

AFTS Submissions  
The Treasury,  
Langton Street  
PARKES ACT 2600

24 April 2009

Dear Sir

### **Australia's Future Tax System (AFTS)**

Enclosed is a submission <sup>1</sup> outlining a number of ideas for reform of Australia's tax system in response to the Review Panel's invitations of August and December 2008. It formalises a number of email exchanges and a meeting held with Treasury officials on simplifying/eliminating tax return preparation in late 2008, raises an additional issue concerning weaknesses in tax system design, leading to what I describe as a 'systemic compliance imbalance', and provides comments on a specific idea raised in Treasury's consultation paper.

The ideas made in this submission draw directly and extensively on my work and experience in international tax system administration, particularly in my current position with the OECD's Centre for Tax Policy and Administration, and extensive earlier experience as a senior executive with the ATO.

If further information is required, I can be contacted as follows:

[removed for privacy reasons]

Yours sincerely

Richard Highfield

c.c. Commissioner of Taxation

---

<sup>1</sup>The writer is a Senior Advisor with the OECD's Centre for Tax Policy and Administration (CTPA) and led the CTPA's work on tax administration from 2003 to 2007. Prior to this, he was a senior advisor in the IMF's Fiscal Affairs Department and a Second Commissioner of Taxation in the Australian Taxation Office where he worked for over 28 years. This submission is made in a private capacity and does not reflect the views of the OECD or the CTPA.

## **Australia's Future Tax System Submission by Richard Highfield**

### **Summary**

This submission outlines a number of specific ideas for reform of Australia's tax system to deliver on two fundamental objectives:

- 1) To achieve substantial reductions in taxpayers' compliance costs; and
- 2) To achieve significant improvements in taxpayers' compliance with the tax laws.

In line with concerns expressed in Treasury's consultation paper for the complexity of Australia's personal income tax, and associated operating costs, Part 2 of this note outlines two approaches to radically reform annual tax return preparation requirements and presents the case for a technology-focussed approach—described as the '*technological path*'. The proposal made draws on highly successful developments already being witnessed in Nordic region countries, in particular, Denmark. It also identifies a range of complementary legislative reforms that would be needed to achieve optimal outcomes from this approach.

Part 3 of the submission describes weaknesses in the taxing arrangements resulting from the relative absence, compared to many other countries, of tax withholding and information reporting arrangements and provides some insights as to the likely implications for the levels of taxpayers' compliance achieved in practice. Noting the extent of this weakness, the potential for substantially increased revenues, and the inability of existing administrative tools to deal as effectively with this non-compliance, the submission recommends a substantial increase in the use of systematic information reporting requirements covering a prescribed range of income categories (and a withholding sanction for taxpayers not properly identified). This proposal also draws on overseas practices and developments, as described in the submission.

Finally, the submission provides comments on the idea expressed in Treasury's consultation paper concerning the provision of a single client interface for the tax and transfer system. For the reasons expressed therein, this writer expresses strong doubts as to the merits of the idea of creating a central agency to administer individuals' tax and transfer obligations.

## Australia's Future Tax System

### Part 1. Introduction

1. This submission focuses on the issues of complexity (and resulting compliance burden) and taxpayers' compliance (and associated revenue leakage), principally in respect of Australia's personal income tax (PIT).
2. Part 1 provides some contextual comments concerning complexity and taxpayers' compliance.
3. Part 2 identifies two approaches for personal tax return filing simplification—described as the '*legislative*' and '*technological*' paths respectively—and argues a case for latter.
4. Part 3 argues the case for a major expansion of new information reporting arrangements, building on advances in technology among government and business, to reduce systemic non-compliance, thereby increasing government revenues, improving equity among taxpayers and, potentially, assisting taxpayers meet their return filing obligations.<sup>2</sup>
5. Part 4 provides comments on the idea expressed in Treasury's consultation paper concerning a single client interface for the tax and transfer system.

### **Context for reform**

#### *Complexity*

6. The complexity and associated compliance costs of Australia's tax system are widely acknowledged and recognised in Treasury's architecture and consultation papers. While it is generally the case that business is seen to be the primary target of much of the tax system's compliance costs, personal taxpayers also are exposed to substantial compliance costs. This submission focuses principally on reform of the personal income tax.
7. As noted in Treasury's architecture paper, there is a dearth of contemporary and reliable information on the nature and incidence of the compliance burden of Australia's tax system<sup>3</sup>. (In my view, this gap in tax system governance warrants a reform response in its own right.) However, it is possible to make a number of observations that are indicative of the existing system's relative complexity (compared to many other developed countries) and the resultant substantial burden for taxpayers:
  - Australia is one of around 15 OECD countries that generally requires an annual tax return from all its personal taxpayers. In the remaining 15 OECD countries most employees, who represent the vast majority of personal taxpayers, are freed of the obligation to prepare an annual return through the use of final withholding type arrangements and other tax system design features (e.g. very limited range of deductions) that negate the need for an end-year return.

---

<sup>2</sup> The ideas expressed in this part draw on work I am currently leading for the OECD's Forum on Tax Administration. Publication of the outcome is expected by around June 2009.

<sup>3</sup> As noted in Treasury's architecture paper, there have been only two detailed studies of the costs of complying with Australia's main taxes, including the personal income tax (PIT). These were the ATO-commissioned study by ATAX based on 1994-95 survey data, and an earlier study left by Jeff Pope (1994) based on 1990-91 data, both now exceptionally dated pieces of work.

- In the 15 or so countries where a tax return is generally required from all taxpayers, steps have been taken by a number of revenue bodies to automate the preparation of returns for taxpayers, applying a concept known as 'pre-filing'. In its most advanced form (i.e. in Denmark), application of pre-filing has enabled the abolition of annual tax returns for the vast majority of personal taxpayers (refer later comments). The Australian Taxation Office has some taken steps in this direction, but substantially more can be achieved with Government support (refer later comments).
- The ATO's publication 'Taxpack' that is published to inform and systematically guide taxpayers on their return filing obligations details some 40 topics (with a countless array of sub-questions) over 140 pages that taxpayers are expected to examine each year as part of the tax return preparation process.
- Around 73% of all personal taxpayers in Australia engage a tax professional for tax advice and the preparation of their annual tax returns—this is the highest rate of tax professional usage observed in any OECD country.
- The ATO's Community Perceptions Survey 2008 (prepared by Research International) offers some telling insights into how personal taxpayers perceive the tax system:

*"Almost half of the community remain confused about taxation matters and over a third feel uncomfortable with, and disengaged from, the system" (page 8).*

*"Motivations for using a tax agent remain to be in regards to individuals' concerns about ensuring their return is correct (18-50 year olds in particular) and avoidance of doing it themselves as it is perceived as complicated (50+ years in particular) (page 10).*

*"There are also significant sections of the community who feel they lack understanding and knowledge in taxation matters. Females and those in lower income households who remain the most likely to be disengaged and lack understanding of the tax system along with the older 50 years and over segment of the population." (page 14).*

*"There is a concerning trend that confusion over tax matters has increased from last year, perhaps due to changes in the tax system that were occurring just before and around the time that the survey was administered" (page 14).*

8. In the absence of reliable contemporary information, one can only speculate as to the actual magnitude of compliance costs for the PIT in 2008-09. Clearly, the law in 2009 appears more burdensome than when the issue of aggregate compliance costs was last formally studied, with various legislative "add-ons" over the years, significantly increased numbers of taxpayers subject to the capital gains tax (CGT) provisions, increased linkages with government transfer arrangements, and in the absence of any substantive simplification efforts over the last decade or so. While there have been numerous improvements in administration of the system (e.g. electronic filing of tax returns, Internet information access, and portal facilities for tax agents), the remaining burden nevertheless appears substantial. As noted in Treasury's paper ... *"there is a strong sense in the community that the operating costs of the tax (and transfer) system are too high"*.
9. Broad community recognition of all of these sorts of factors has resulted in many calls over a fair period of time for reform that would radically simplify, if not eliminate, tax return preparation for most taxpayers.

### *Taxpayers' compliance*

10. Also relevant in a tax reform context, but not specifically dealt with in either Treasury's architecture or consultation papers, is the extent to which the design of the tax system is optimised to achieve its objective of raising and collecting the proper amount of tax (or as near to it as practicable) for each tax administered, thereby ensuring equity among taxpayers as well as delivering the funds required by Government. This objective, which I describe as 'taxpayers' compliance', has both policy and administrative dimensions:
- 1) Does the tax system make optimal use of mechanisms that are widely recognised as that contributing to the achievement of high levels of taxpayers' compliance (i.e. withholding and/ or information reporting obligations)?
  - 2) Where they are available, are these mechanisms being used in an optimal manner?
11. Unfortunately, there is also a dearth of information available at the aggregated level in Australia on the overall incidence of taxpayer's non-compliance with the laws.<sup>4</sup> However, this shortcoming aside, I believe it is possible to argue both intuitively and on the basis of the approaches and experience of other countries that administer similar taxes that there are design weaknesses in Australia's current taxing arrangements resulting in what I describe as a "*systemic compliance imbalance*". Furthermore, this imbalance is likely to involve a considerable amount of tax revenue that goes uncollected using existing administrative methods. Ideas to address this imbalance are discussed later in this submission.

---

<sup>4</sup> This is an area where the Commissioner currently has work underway that would enable the ATO to account far more comprehensively for its effectiveness in having taxpayers comply with the various tax laws. The OECD has done recent work in this area and I have been working with ATO officials on the development of a set of compliance effectiveness measures (including tax gap estimates).

## Part 2. Simplifying the personal income tax to reduce the compliance burden of taxpayers <sup>5</sup>

12. This part provides some contextual background concerning the operation of existing PIT system and a range of factors to be considered in the context of achieving a radical simplification concerning tax return preparation. It describes two options for reform, described as the *'legislative path'* and the *'technological path'*, provides commentary on the pros and cons of both, and concludes with a recommendation that the *'technological path'* be considered as the most suitable and viable in an Australian context. It is directly relevant to Q8.2 posed in Treasury's Consultation paper:

*"In what ways might the administration of Australia's tax-transfer system be changed to better meet the needs of individuals and businesses? How might the process of personal tax returns be simplified, including by removing the requirement for some taxpayers to lodge returns? Should the administration of the system be more integrated (across taxes and transfers and between jurisdictions)? How might advances in technology assist?"*

### The role of annual tax returns and assessments

13. Under existing tax law, all personal taxpayers (including all employees) are required to file an annual tax return. Taxes withheld at source are calculated by employers in a relatively simple way, representing an approximation of each taxpayer's end-of-year tax liability that is calculated on the basis of information reported in each taxpayer's annual tax return. While the tax return process fundamentally therefore aims to establish exactly how much each taxpayer should pay, there are important aspects related to this objective that need to be borne closely in mind in the context of thinking about how the process could be simplified for most taxpayers (e.g. by relieving them of the requirement to prepare and file a return). For example:

- **Taxing all income:** Generally speaking, only employment and pension incomes are subject to tax withholding at source arrangements. Australia's tax system, unlike most other OECD countries, does not require withholding of tax at source on interest or dividend income. Similarly, with the demise of the Prescribed Payments System in 2000, there is no withholding of certain categories of self-employment income. Furthermore, a significant number of taxpayers have an exposure to the Capital Gains Tax Provisions of the income tax law; here also, there is neither withholding nor systematic reporting (like wages and investment income) to the ATO.
- **Tax deductions and offsets:** Given the relative simplicity in the design of PAYGO employers' withholding schedules, employee taxpayers must file a tax return to claim the benefit of various tax deductions and offsets provided under the tax law. The most significant deduction claims are work-related expenses (claimed by 7.6 million taxpayers), tax agents' fees (5.3 million), and gifts (4.3 million). While there are a large number of various offsets claimable by taxpayers, no individual offset is claimed by more than around 0.7 million taxpayers. (NB: There are numerous other offsets that are calculated by the ATO from information contained in returns.)
- **An assessed taxable income:** Government benefits/ entitlements / requirements (e.g. family allowances, Medicare surcharge, baby bonus, and child support) operate on the basis of an established taxable income that is derived from the annual tax return process. Abolishing tax returns under any scenario would require some other

---

<sup>5</sup> All of the Australian tax systems-related data contained in this Part are in respect of the 2006-07 financial year, unless otherwise indicated.

process to be contrived to establish annual incomes of individuals and families for means-testing, determining liability to surcharges etc.

- **Higher education contribution (HECs):** An assessed taxable income is the trigger for determining any tax liability in respect of a HECS debt. There are over 1.2 million HECS debtors and around 300,000 HECS repayments are recouped annually through the tax return assessment process. This number can be expected to grow in line with growth in overall numbers of HECS debtors and their incomes.

14. These are all important considerations in contemplating reform options intended to simplify tax arrangements for a significant proportion of taxpayers.

### **Eliminating tax returns for most personal taxpayers**

15. For tax year 2006-07, around 11.7 million citizens filed an annual tax return. Of these, around 7.1 million were classified as employees, as salary income was their predominant source of income. Of those taxpayers deemed employees, the majority used the services of a tax professional. Given the high proportion of employees comprising the PIT population, it follows that any reform that freed the majority from having to prepare a tax return would produce enormous benefits for them.
16. One of the most frequently made suggestions for reform and simplification of the PIT is elimination of the need for (most) employee taxpayers to file an annual tax return. The rationale for this suggestion generally goes along the lines that these taxpayers pay all of their taxes via the PAYGO withholding arrangements as income is derived during the year and the end-year return simply serves to effect a reconciliation with a small refund typically the outcome. Proponents of this suggestion also frequently argue that to facilitate such a reform deduction entitlements such as work related expenses (WREs) should be "rationalised" and the amounts of tax withheld at source calculated in a way so that no tax is owing or refundable at year-end for most taxpayers. The point is sometimes made that such arrangements operate successfully in other countries (e.g. the United Kingdom) and that Australia should take a similar path to achieve the supposed benefits.
17. In my view, there is a strong argument for freeing most employee taxpayers in Australia from the obligation to prepare and file annual tax returns, given the sheer effort involved under existing arrangements. This reform effort will have failed to a fair degree if such a reform is not one of its outcomes. However, drawing on a broad range of international experience, there are two fundamentally different approaches that can be taken for achieving this outcome and it will be critically important for the review to weigh the pros and cons of each. In this submission, I describe these approaches as the '*legislative path*' and '*technological path*'. In the following comments I describe these two approaches and present a case for the latter, taking account of the overall requirements of Australia's tax and transfer arrangements.

### **Options for relieving most personal taxpayers of the need to prepare tax returns**

18. As noted earlier in this submission, the majority of OECD countries have established arrangements as part of their personal tax system design and administration that free the majority of employee taxpayers from having to prepare and file an annual tax return. For reasons that will become obvious, these arrangements fall into two broad and distinct categories that I describe as the '*legislative path*' and the '*technological path*'. I describe each of these approaches hereunder along with commentary on their pros and cons in an Australian context.

### ***The legislative path***

19. There have been numerous suggestions over the years in Australia for the abolition of tax returns for a significant proportion of taxpayers. One of the most recent is contained in a report of the Joint Committee of Public Accounts and Audit (JCPAA).<sup>6</sup> While none of these has been described in terms of a '*legislative path*', it seems reasonably clear that just about all of the suggestions have envisaged a set of legislative initiatives constituting what I describe as a '*legislative path*'. In brief, the '*legislative path*' would entail reforms to the tax law along the following lines:

- 1) The introduction of a more exact form of withholding, known as '*cumulative withholding*' for collecting income tax on employment income, to ensure that as far as is practicable, the exact amount of tax is withheld at source and no amount is payable/ refundable at the end of the year);
- 2) Rationalisation of certain tax deductions (e.g. work related expenses), tax offsets etc (that under existing arrangements can only be claimed by taxpayers in their end-of-year tax return); and
- 3) Introduction of additional withholding mechanisms in respect of other major categories of income (e.g. interest and possibly some dividend income).

### *Withholding regimes for employment income*

20. The JCPAA observed that return-free arrangements require an accurate system of withholding, one designed with the objective of enabling employers to deduct withholdings over the course of the fiscal year that more or less match each employee's end-of-year tax liability. In tax administration literature, these arrangements are often termed '*cumulative withholding*' regimes. The UK is one of many OECD countries that uses such a regime for the collection of taxes (and National Insurance Contributions (NICs)) from its employees and its PAYE regime is often lauded (in my view, somewhat out of ignorance) given that it frees the majority of employees from the obligation to file an annual tax return. A brief understanding of how the UK PAYE system operates in practice is informative.

21. Under the UK arrangements, every employer is required to calculate withholdings for each of their employees on a cumulative basis throughout the year, applying a system of coding administered by the revenue body for each employee that prescribes the amount of tax to be withheld having regard to the their personal circumstances. First-time employees must inform the revenue body as soon as they commence work, which in turn informs employers of the appropriate PAYE coding to be applied. Employees changing jobs and their employers during the fiscal year must "carry" their tax records to their new employer (who is required to continue the 'cumulative' process) and inform the revenue body. Provided this is done, the revenue body then informs the new employer of the PAYE code applicable to the individual employee. Employers report all relevant details to the revenue body shortly after the end of the fiscal year.<sup>7</sup> This enables the revenue body to

---

<sup>6</sup> See '*Report 410, Tax Administration, Joint Committee of Public Accounts and Audit (JCPAA)*', June 2008. In their report, the JCPAA pointed to the complexity of Australia's personal tax arrangements and the attendant compliance costs for taxpayers. To achieve substantial reductions in taxpayers' compliance costs, it recommended that consideration should be given to reducing the numbers of taxpayers who are required to lodge annual tax returns. In its view, this could be achieved by the following "enabling" reforms: a) Adopting a more accurate withholding regime for employment income; b) Abolishing deductions for employees' work related expenses (WREs); c) Simplifying the tax rate structure; and d) Converting numerous tax offsets, rebates etc to direct payments to taxpayers.

<sup>7</sup> In New Zealand's system, employers must report similar information on a monthly basis.

- undertake a process of matching and vetting to ensure that the proper amount of tax has been paid on each employee's incomes. While most employees—in practice, around 2/3rds of all personal taxpayers—are not generally required to file a tax return, the process of matching and vetting undertaken by the revenue body leads to the identification of both 'under' and 'over' payment situations that (beyond thresholds) must be followed up by the revenue body. In practice, underpayments are often collected via adjustments to future withholding, an additional factor that employers must take account of in their PAYE administration responsibilities. The operation of the PAYE system is complemented by separate withholding mechanisms in respect of interest and dividend income (as part of which tax is deducted at the basic rate of PIT), strict limits around work-related deductions, and dealing with gifts outside of the tax system. However, the wage and investment income withholding systems operate largely independently of each other and there is no attempt to amalgamate information for each taxpayer. As a result, most taxpayers are not presented with a formal summary of their aggregate income and the tax paid for a fiscal year.
22. By way of contrast, the withholding arrangements currently operating in Australia (as well in Canada and the USA) can be described as 'non-cumulative' withholding regimes. Under these arrangements, employers need only deduct tax on a 'pay period' basis applying official withholding scales and taking account of information provided by employees in their employment declarations. Where an employee changes jobs, the new employer simply commences withholding tax from earnings on a prospective basis, with no regard to the employee's prior job tax position. With minor exceptions, there is no in-year intervention by the revenue body at the individual employee level and the system operates, from the viewpoint of the revenue body, at relatively little cost. At year-end, employees are normally required to file tax returns to finalise their overall tax position and determine any amounts payable or refundable (NB: An alternative to this requirement is described under the 'technological path'). Employers, for their part, must report all relevant details to the revenue body, which are matched with taxpayers' records to ensure the correct reporting of their income and withholdings. While desirable from a tax collection viewpoint, withholding mechanisms are not essential in respect of interest and dividend income, and this is the case in practice in Australia, USA and Canada.
23. ***Given the imperative of achieving accurate 'in-year' withholdings, there seems little doubt that cumulative withholding regimes of the UK-ilk require far more complex record-keeping by employers for each employee and closer 'in-year' monitoring of employees, by both employers and the revenue body.*** While I don't profess to have an intimate knowledge of their workings, my intuitive judgment is that they are clearly more burdensome (read 'costly') on employers than the PAYE arrangements currently operating in Australia (and in other countries with similar arrangements). Furthermore, the costs to the revenue body are by no means trivial and I have long suspected that the overheads associated with PAYE administration in the UK are one of the reasons why it is relatively quite larger in staffing terms (at least by 15%) than its Australian and Canadian counterparts. However, there are other more serious reasons to be sceptical—recent reports by the UK National Audit Office (NAO) indicate that administration of PAYE is experiencing major problems (see Box 1).
-

**Box 1. The UK PAYE arrangements—Some recent issues with their administration**

In a report published in July 2007,<sup>8</sup> the NAO provided a detailed exposition of how these arrangements operate in practice. In short, the arrangements described appeared quite burdensome and administratively cumbersome for both employers and the revenue body and, at the end of the day, imprecise for a fair number of taxpayers. Among other things, the NAO's report referred to a very high incidence of employees—some 30%—with year-end 'under' and 'overpayment' situations requiring clerical intervention by the UK revenue body. In its report, the NAO identified a number of factors contributing to this situation including;

- a) the increasing complexity of the employment market;
- b) the growing frequency of employees changing jobs and/or having multiple sources of employment income;
- c) failure by many employers and employees to provide accurate and timely information to the revenue body;
- d) inadequate computer system support in HMRC.

A more recent NAO report<sup>9</sup> noted a continuation of this situation and observed that the volume of unresolved 'over' and 'under' payment situations at end-March 2008 stood at around 16.2 million, roughly equivalent to three cases for every four employees administered by the regime.

24. Similar concerns for the functioning of the UK PAYE system are the subject of comment by the authors (two from the UK, one from the US) of a paper recently submitted to a review of the UK tax system.<sup>10</sup> They note that ..... "*Over recent decades PAYE has been the object of sustained criticism arguing that it is less able to cope and needs to be reformed*". They also suggest that a feature of the UK arrangements is their inherent lack of flexibility for the framing of Government personal tax policy, given the practical limitations applying to what employers can be expected to carry out. Notably, in their concluding comments they canvas some possible approaches to future reform, including..... a system of universal self assessment incorporating pre-filled tax returns!
25. Given the facts as presented, I have serious reservations as to the suitability/ feasibility of cumulative withholding arrangements in an Australian context. Furthermore, I believe there is a better approach that is described in later comments.

*Rationalisation of certain deductions and offsets*

26. As noted earlier, the annual tax return provides the means for taxpayers to claim their entitlements to certain deductions and tax offsets (that cannot be taken account of in the wage withholding process). The most common deductions are work-related expenses, claimed by around 7.4 million employees and gifts (claimed by 4.2 million taxpayers, around 60% who are employees). The most common offsets are seniors, medical and zone, although claims for any of these items do not normally exceed 0.6 million.

---

<sup>8</sup> See HM Revenue Customs 2006-07 Accounts, The Comptroller and Auditor General's Standard Audit Report (6 July 2007).

<sup>9</sup> See 'HM Revenue Customs 2007-08 Accounts, The Comptroller and Auditor General's Standard Audit Report' (10 July 2008)

<sup>10</sup> See 'Administration and Compliance' (Shaw, Slemrod and Whiting) prepared for the Report of a Commission on Reforming the Tax System for the 21<sup>st</sup> Century, chaired by Sir James Mirrlees, 2008.

27. The JCPAA singled out **employees' work-related expenses (WREs)** as an area of the tax system requiring attention to reduce return filing obligations. Many parties, including myself, have long advocated reform of WREs. From a tax system management viewpoint, they raise two serious concerns.
28. First, there is a significant compliance burden for the vast majority of employee taxpayers making WRE claims, resulting from the requirements to keep records, prepare deduction claims or engage a tax professional to do so and, for some taxpayers, to handle related inquiries by the ATO.
29. Second, WREs are a source of revenue leakage as a result of deliberate or careless over-claimed deductions and exaggerated interpretations of the law, and the problem appears to be increasing. For the 2006-07 financial year, aggregate deductions for WREs amounted to \$14.2 billion on behalf of around 7.6 million taxpayers. Over the last ten years, WREs have grown at a rate well in excess of underlying wage income. WREs are now claimed by six out of every seven employees, and the claim rate comes close to universality for employees with incomes between \$30-100,000 where it is around 90%. For 2006-07, the average deduction claimed by all employee taxpayers making a WRE deduction claim was \$1,860. There is also a clear pattern of average claims increasing with employment income, while some occupational groups (e.g. nurses and politicians) have a very high incidence of relatively large claims.
30. The ATO does not carry out research to develop representative compliance benchmark data on WREs or other areas of the tax return. However, based on my experience and observations of compliance research patterns in this area of the tax system in Canada (a country with a similar tax system and administrative arrangements to Australia), the incidence of over-claimed deductions could well be in the region of 10-15% per annum. In aggregate terms, this non-compliance would represent over-claimed deductions of between \$1.4-2.1 billion and revenue leakage of \$280-420 million per annum. No tax system can achieve perfect compliance, but a non-compliance issue of this magnitude clearly justifies attention in a reform context. In my view, it is no longer an issue than can be resolved administratively, particularly given other demands on the ATO's resources.
31. In their report, the JCPA canvassed the idea of abolishing deductions for WREs in order to simplify the system (and facilitate the scrapping of tax returns). Although not stated specifically, the JCPAA presumably envisaged that abolition of WREs would be offset by a reduction in marginal tax rates to compensate taxpayers for the deductions foregone.
32. The suggestion to abolish WREs has been raised by others and, given the high incidence of claims and their concentration in some occupational groups, my sense is that such a proposal would raise significant political and equity considerations. On the one hand, denying deductions for around 7.6 million employee taxpayers who bear the bulk of the personal tax burden and who most likely represent the most compliant group of all personal taxpayers would, I consider, be hard to sell in a political context. There is also a significant equity issue associated with distributing the benefits of any saved revenue (from their abolition) across the broader personal taxpayer population. However, there are other options for reforming WRE deductibility.
33. From my experience, no other country's tax system is exposed to such a high incidence of itemised claims for WREs. Many countries strictly limit what WREs can be claimed as a tax deduction, while others have introduced a standard deduction, either set as a fixed amount or as a fixed percentage of employment income. In all cases, the objective is to strictly limit the number of individually itemised deductions claimed in tax returns.
34. Given the pervasiveness of WRE claims in Australia and the fact that they tend to increase with income, I have previously suggested that a standard deduction set as a fixed percentage of employment income, along with provision for itemised claims in

- exceptional situations <sup>11</sup>, might represent a more acceptable approach to reform. In short, a standard deduction for 80-90% of the employee population, with the balance being able to itemise their (much larger) claims. A standard deduction along these lines could be readily incorporated into PAYG withholding schedules thus permitting taxpayers, should they wish, to derive its benefit during the year. Obviously, the feasibility and precise design of any standard deduction would need to be assessed having some regard to existing claim patterns. However, given that a fair proportion of claims are fraudulent, wrong in law and/or based on exaggerated interpretations of the law I would recommend that a fairly ruthless approach be taken to setting the parameters for any standard deduction that is contemplated, and that the exercise not be overly swayed by modelling results around the balance of “winners and losers”.
35. An alternate approach for reform of WRE could entail the introduction of a *de minimis* rule— employees could only claim a deduction for an excess of deductions where their aggregate WRE deductions were greater than a fixed \$ amount (along the lines as currently applies for medical expenses) or a fixed percentage of employment income. The limits would need to be set sufficiently high to keep the level of itemised claims made by taxpayers to a minimum.
36. Introducing a standard deduction set at a level to significantly limit the number of individual itemised claims should quickly lead to significant reductions in compliance costs in this area of the tax system and would alleviate what I see as a growing non-compliance “nuisance” for the ATO. It would also make a significant contribution to the cause of simplifying tax return preparation and by reducing the need for taxpayers to engage tax professionals should in time significantly reduce the number of **deduction claims for the use of tax agents services** (another area of significant deductions with over 5.3 million claims each year).
37. Deductions for **gifts** represent another “nuisance” item in tax system design and administration—lots of claims (around 4.3 million per annum), but relatively insignificant in terms of their overall value (around \$1.9 billion per annum). In the context of reforming tax return preparation, there appear to be a number of options:
- 1) Remove deductibility from the tax system and instead directly compensate gift recipients with a co-contribution (a possibility foreshadowed in Treasury’s consultation paper);
  - 2) Deny deductibility for small value gifts (e.g. all individual gifts below \$100);
  - 3) Incorporate deductions for gifts into some form of standard deduction introduced to sweep up other deduction items (as discussed for WREs).
38. I have no particular preference re 1), 2) or 3) other than a desire for reform that eliminates large numbers of relatively small value claims.
39. **Tax offsets** also figure prominently in the tax system in terms of the absolute number of them but, individually, they apply to a relatively small subset of the taxpayer population. As described in Table 1 below there is potential for rationalisation/ alternative forms of treatment, thereby removing them from the tax system.

---

<sup>11</sup> For example, claims that exceed a prescribed threshold (e.g. 2-3 percent over the value of the standard deduction percentage) to encourage use of the standard deduction.

**Table 1. Selected tax offsets and possible simplification-related options**

Tax offset	Tax offsets (2006-07)		Suggested reform approach
	No. (mln)	Value (\$mln)	
30% health insurance	0.264	174	Deliver 'benefit' to taxpayer via lower insurance fund subscriptions, an option in the current system
Baby bonus	0.313	182	If retained, remove option to pay bonus from tax system & pay via the transfer system.
Child care rebate	0.395	359	Removed from the tax system for 2008, (hopefully a portent of similar reform for other areas!)
Zone	0.552	234	
Senior Australians	0.622	1116	Eliminate from the tax system as part of a 'base broadening/ lower rates' strategy underpinning overall tax reform goals.
Mature worker	1.2	510	

40. The issues raised under this heading apply equally to the *'technological path'* described later in this submission.

#### *Additional withholding mechanisms*

41. A fact overlooked in the recent JCPAA report concerns the taxing of interest and dividend income. Most taxpayers (including employees) are likely to have at least one bank account and many derive interest income, albeit relatively small amounts for many taxpayers. OECD references confirm that all countries with return-free filing regimes for employees also apply withholding regimes (final or creditable) for collecting tax on interest and dividend income (that operate in parallel with their cumulative wage withholding arrangements).
42. Unless there is a major policy change in Australia concerning the taxation of interest income, the *'legislative path'* would need to include provision for a withholding mechanism to avoid the need for tax returns simply because a taxpayer derives some amount of interest income. Introduction of a general withholding requirement for interest income would also have direct and significant implications (read 'added complexity') for the operation of the PAYGO instalment regime, and could impact many taxpayers.
43. The situation regarding dividend income is more complex in Australia given the system of imputation in place. On the assumption that imputation is retained, it is difficult to see return-free arrangements being applicable to taxpayers deriving franked dividend income (between 3.0 to 3.5 million taxpayers in aggregate, including many employees).

#### ***The technological path***

44. The *'technological path'* as described in this submission envisages extensive use by the ATO of technology and associated information reporting systems to automate the preparation of tax returns (applying a concept of pre-filing) and assessment calculations for taxpayers. Under this scenario, the ATO would have the primary responsibility for preparing an initial tax return for most of its personal taxpayers. In its most advanced form once fully established, most taxpayers would receive their assessment electronically, with the underlying detailed information used to compile it accessible via an electronic personal tax folder that would be maintained for each taxpayer. (There would be a paper-based regime for those taxpayers not wishing or able to communicate via the Internet.)

*The emergence of pre-filled tax returns*

45. One of the most significant compliance burden reduction initiatives observed across OECD countries over the last decade has been the development of pre-filled tax returns for personal taxpayers. Pre-filing entails the use by revenue bodies of information received from third parties (e.g. employers and financial institutions), along with other information held by them, to generate complete or largely completed tax returns (electronic or on paper) for the majority of their taxpayer population.
46. In their most advanced form (in the Nordic region countries), the revenue body is capable of producing a fully-completed tax return for most personal taxpayers, along with accompanying detailed calculations of liability. The most successful country to date has been Denmark where the concept originated and has been refined over the last 15 or so years. In 2007, some 72% of Danish personal income taxpayers received a fully completed return. ***In 2008, Denmark dispensed with the actual sending of the detailed return to taxpayers, and simply sent them the final calculations; taxpayers could, if they wished, access the underlying return information either electronically or on paper. In other words, for most Danish taxpayers, return form preparation has been eliminated.***<sup>12</sup>
47. Pre-filing tax return systems rely extensively on timely and comprehensive third party reporting to the revenue body (e.g. by employers, public companies and financial institutions), a high integrity taxpayer identifier, compatible legislation (e.g. standard deductions or deductions that are subject to reporting to the revenue body), extensive use of modern information technology systems, and a high degree of administrative attention given to achieving full compliance with reporting obligations and a very high degree of data accuracy.<sup>13</sup> Generally speaking, taxpayers are not required to respond if they consider that their pre-filled return and related calculations are correct; on the other hand, taxpayers are obligated to inform the revenue body of any additional information relevant to the calculation of their tax liabilities. Over recent years, pre-filing has been adopted to varying degrees by a growing number of other countries (e.g. Belgium, Chile, France, Portugal, and Spain), while The Netherlands introduced a system of pre-filled tax returns in 2009.
48. The ATO has been operating a pre-filing application since 2004—on a very limited basis up to the 2007 tax year — as part of its e-filing service and this was noted positively by the JCPAA in June 2008. However, the JCPAA did not seem to appreciate the potential for its further development and, as already noted, suggested an alternative strategy for major reform.
49. For 2008-09, the ATO expanded considerably the amount of information that could be used by taxpayers to pre-fill their returns and by all accounts this has been highly successful. In his recent report to the JCPAA for its 30 March 2009 meeting, the Commissioner noted that demand for pre-filing in 2008-09 had far exceeded previous year usage (e.g. 1.7 million requests by individuals (up almost 20% on 2007-08) and 4.1 million requests by tax agents (up 143% on 2007-08). The conclusions one can draw from these results seem fairly obvious—*taxpayers very much like this form of assistance!*
50. However, there remains scope for substantial further refinement of the ATO's pre-filing capability, particularly with relevant legislative support. For example:

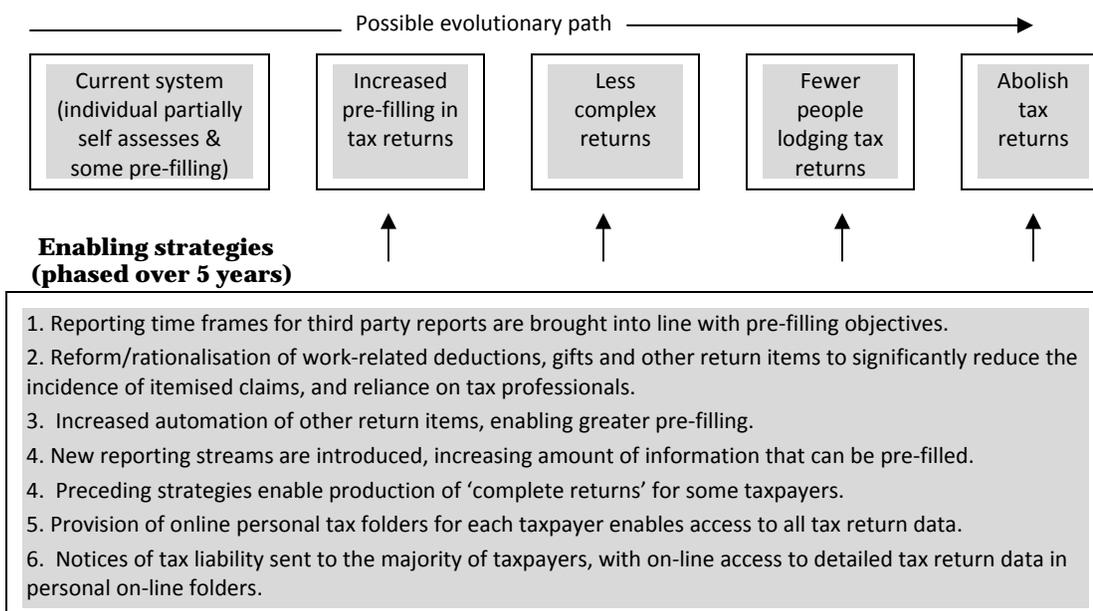
---

<sup>12</sup> A brief description of the Danish approach and its evolution is set out in the recent OECD publication 'Tax Administration in OECD and Selected non-OECD Countries (2008)'.

<sup>13</sup> Conceptually, it is akin to the process credit card companies (e.g. American Express) have been undertaking for many years on a monthly basis—the generation of a monthly statement for each client setting out all relevant transactions and the client's overall accounting position.

- ***Expedited reporting of third party data:*** Under existing tax law, employers have around 6 weeks after the end of the financial year to report details of individual employees' income to the ATO. Payers of interest and dividends have some four months to report to the ATO. These reporting timeframes were designed for an environment of post-assessment checking and are incompatible with optimal use of pre-filing for return preparation purposes. Nordic countries operate with timeframes of between 3 to 4 weeks. Advancement to the reporting timeframes for employment and investment income would appreciably expand the potential of the ATO's pre-filing capability.
  - ***Rationalisation of deductions and offsets:*** As noted in earlier comments for the '*legislative path*', reform of deductions and offsets is an essential prerequisite for any reasonable level of return-free filing and simplification.
  - ***Administrative refinements:*** A system for automating return form preparation by definition requires comprehensive and accurate taxpayer information. I suspect there is scope within the ATO's existing operations to make improvements in each of these areas.
  - ***New information streams:*** Pre-filing type arrangements fundamentally require comprehensive taxpayer information. So far as employee and investor type taxpayers are concerned, a noticeable gap in existing information reporting obligations concerns the capital gains tax, for which there are none. While it will never be possible for any pre-filing capability to automatically compute a taxpayer's 'net capital gains' reporting the existence of CGT events for all relevant taxpayers should be an agreed objective, particularly given the number of taxpayers affected (see further comments in Part 3). Systems in Nordic region countries operate with this level of sophistication. In addition, there is potential for other new information streams, also discussed in Part 3, which could expand the potential for pre-filing type approaches into the business sector.
51. Subject to attention being given to each of the abovementioned issues, and in line with overseas developments, it should be possible to fully automate return form preparation for a significant proportion of the employee and investor taxpayer population, perhaps in the region of 65-75% within a 3-5 year timeframe. Fully developed along the lines described, these arrangements would see the majority of taxpayers concerned receiving an annual assessment of their liability, either in electronic form or on paper, with provision to access via the Internet detailed underlying information to determine the accuracy of the assessment. In situations where it was necessary, adjustments would be advised by taxpayers, enabling a re-assessment of their liability.
52. ***Significantly, such an approach to eliminating traditional tax returns would be compatible with the requirements of the tax and transfer system that rely on the derivation of an annual taxable income (i.e. HECS, Child support, welfare means testing, and Medicare surcharge). Indeed, the rapid accumulation of taxpayer information and assessment-related data could be utilised by the transfer system to verify taxpayers' entitlements to transfer payments, perhaps, in new streamlined and more efficient ways than is currently the case.***
53. The scenario described is broadly consistent with the possibility envisaged by Chart 8.1 of Treasury's December 2008, as depicted hereunder and adapted:

**Chart 8.1: Simplifying personal income tax returns**



***Weighing the pros and cons of the legislative and technological paths***

54. Given the stated desire to achieve a major simplification of the tax system for personal taxpayers, consideration of what has been described broadly as the legislative and technological paths appears inevitable. A summary of the perceived pros and cons of each approach, for both assuming a rationalisation of major deduction and offset items, is set out in Table 2. For the reasons stated therein, this writer strongly recommends adoption of the 'technological path'.

**Table 2. Perceived pros and cons of the legislative and technological paths**

Legislative path	Technological path
✓ Frees a significant number of taxpayers from preparing an annual tax return, resulting in significant reductions in compliance costs of individual taxpayers.	
* Imposes new requirements & more costs on employers and employees.	✓ Increased reliance by employers on technology improves efficiency of reporting process
* Imposes new requirements on employees (viz. when changing jobs).	✓ Complements the operation of the transfer and HECs systems.
* Does not complement the operation of the transfer and HECs systems, thereby requiring new processes.	✓ Builds on existing systems & resources; not a fundamental change in direction
✓ Improves the cash flow of employees (but at a cost to government that has previously had use of funds previously refunded at year-end).	✓ Increases the importance and need for integrity with ATO data collection and matching capabilities.
* Requires withholding arrangements for interest income; cost to financial institutions & added complexity for PAYGO system.	✓ Retains the visibility of the annual income tax process and transparency of the income tax system.
* Limits use of refund offset capabilities to collect other debts (e.g. Child Support).	

### Part 3. Reducing the incidence of systemic non-compliance

55. A key consideration in a tax reform context concerns 'effectiveness', or the extent to which the tax system achieves its objective of collecting the proper amount of tax from taxpayers for each tax administered. In tax administration jargon, this is often described as the level of taxpayers' compliance. Effectiveness insofar as it relates to taxpayers' compliance is most frequently viewed as being related to administrative competence. However, it also has a policy dimension—the income tax law provides various mechanisms that, from published research findings, can clearly be shown to contribute significantly to the level of taxpayers' compliance achieved in practice. The main mechanisms are 'withholding of tax at source' and 'information reporting' obligations.
56. In this part, I discuss a major weakness in the design of Australia's income tax system resulting in what I term '*a systemic compliance imbalance*', and associated revenue leakage and inequity. I suggest reforms to alleviate the impacts of this weakness along with a complementary idea to ease the compliance costs associated with their operation.<sup>14</sup>

#### *Tax withholding at source obligations*

57. Withholding at source arrangements are generally regarded as the cornerstone of an effective income tax system. Imposing the obligation on independent third parties such as employers and financial institutions to withhold an amount of tax from payments of income made to taxpayers significantly reduces, if not eliminates, their ability to understate such income for tax assessment purposes, is a more cost efficient way for both taxpayers and the revenue body to transact the payment of taxes, and reduces the incidence of unpaid taxes that might otherwise arise where taxpayers properly report their income but are unable to pay some/ all of the tax assessed. Furthermore, the timely remittance of amounts withheld by payers to the revenue body ensures a good flow of revenue to Government accounts and thereby facilitates budgetary management.
58. As reported in the OECD publication '*Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series 2008*', use of withholding is well-entrenched in the administration of personal income taxes in OECD and other countries:
- 28 of 30 OECD countries apply 'withholding' requirements to the collection of taxes on **employment income**, the major source of personal income; and
  - 22 of 30 OECD countries routinely apply 'tax withholding at source'—either on a final or creditable basis—to **dividend and interest income** paid to investors.
59. However, the use of withholding obligations in relation to other categories of income, in particular to income from business and/or self-employment activities, is more limited although there are some useful examples described later in this submission. Significantly, there are also signs of increasing reliance on these mechanisms for this form of income.
60. From a compliance effectiveness viewpoint, the most important feature of withholding (and associated income reporting) is the very high degree of taxpayers' compliance that can be achieved in practice. Revenue bodies in a number of countries (e.g. UK and USA) have reported voluntary compliance levels of around 99% for income subject to both withholding and reporting (e.g. wages). The comments set out in Box 2 extracted from a US IRS report on this topic clearly support this proposition.

---

<sup>14</sup> The ideas expressed in this part draw on work I am currently leading for the OECD's Forum on Tax Administration. Publication of this work is expected by around June 2009.

**Box 2. IRS: Compliance rates & the visibility of taxpayers' incomes**

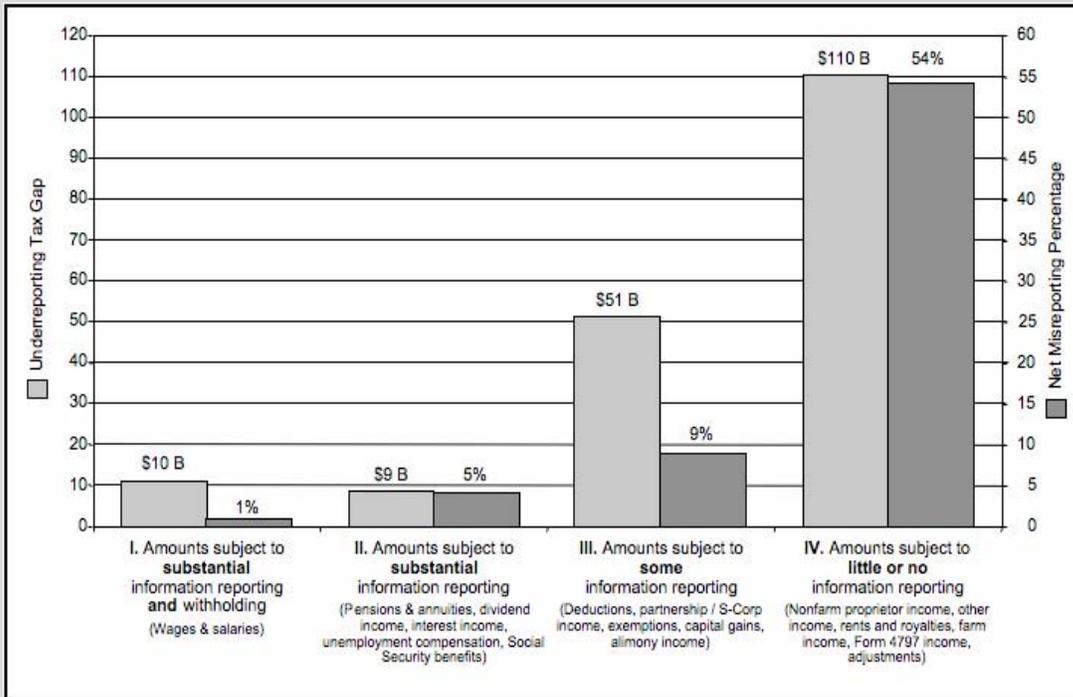
“Figure 5 presents the same (return) line items grouped by the degree to which the items are “visible” to the IRS — that is, the extent to which they are subject to information reporting and withholding. The conclusion is striking: reporting compliance is strongest in the presence of substantial information reporting and withholding. This is illustrated graphically in Figure 6. Although the contribution to the underreporting gap depends on the dollars of income or offset at stake, the net misreporting percentage is clearly inversely related to the degree of visibility.

It appears that compliance rates for sections of the Form 1040 where the most non-compliance occurs have not changed dramatically since the last compliance study for TY 1988. The amounts least likely to be misreported on tax returns are subject to both third-party information reporting and withholding and are, therefore, the most visible (e.g., wages and salaries). The net misreporting percentage for wages and salaries is only 1.2 %.

Amounts subject to third-party information reporting, but not to withholding (e.g., interest and dividend income), exhibit a somewhat higher misreporting percentage. For example, there is about a 4.5 net misreporting percentage rate for items subject to substantial information reporting, such as interest, dividends, pensions, and social security benefits.

Amounts subject to partial reporting by third parties (e.g., capital gains) have a still higher net misreporting percentage rate of 8.6%. As expected, amounts not subject to withholding or third-party information reporting (e.g., sole proprietor income and the “other income” line on Form 1040) are the least visible and, therefore, are most likely to be misreported. The net misreporting percentage for this group of line items is 53.9%.

**Figure 6. Tax Year 2001 Individual Income Tax Underreporting Gap**  
(Misreporting of Income and Offsets by “Visibility” Categories)



Based on updated estimates derived from the TY01 National Research Program study of individual income tax reporting compliance.

With transactions that are less visible to the IRS, and with very low audit rates by historical standards, some sole proprietors may have become emboldened to cut corners on their taxes. Other small business owners may fail to comply fully because they are overwhelmed by the cost and complexity of meeting their tax obligations and their business requirements. Whatever the reasons, there is a serious problem with underreporting for those items not subject to information reporting.”

Source: *Reducing the Federal Tax Gap—A Report on Improving Voluntary Compliance, IRS (08/ 2007).*

### *Information reporting obligations*

61. 'Information reporting obligations' refer to a legislated requirement on the payers of specific categories of income to report periodically to the revenue body relevant information (e.g. name, payee identification number, and amount and date of payment), either as an integral component of a withholding regime or as a separate 'stand-alone' requirement in relation to a prescribed range of payments. Such reports, where they are systematically matched with tax records, enable the revenue body to verify with considerable precision the amount of income reported by taxpayers in their returns, to identify actual/potential discrepancies, and to identify non-filers (deriving assessable income). A more recent development, as noted earlier in this submission, has entailed the use of information reports (and other information) by revenue bodies to prepare pre-filled tax returns.
62. While not as effective as withholding and complementary reporting, detailed compliance research findings published in the USA (as per the findings described in Box 2) clearly evidence the relatively high levels of compliance that can be achieved from effective administration of systematic reporting obligations for prescribed categories of income—compliance levels of around 95%.

### *The absence of withholding and reporting obligations*

63. For those income tax systems where categories of income are subject to neither withholding nor information reporting requirements revenue bodies face the challenge of achieving high levels of voluntary compliance by taxpayers using a mix of administrative tools such as education, service, audits, and debt collection, supported by deterrents and sanctions in the form of penalties and prosecution. These administrative tools are costly for revenue bodies to deploy and given resource constraints must be administered on a selective 'risk assessment' basis. Significantly, the proportion of taxpayers subject to audit and other verification-related activities in relation to business and income from self-employment is well under 5% meaning that the risk of detecting and dealing with non-compliance is quite low. While it is the case that use of these administrative tools can be shown to have an impact in the areas to which they are targeted, in my view there must be considerable doubt as to the sustainability of these impacts as other targets are chosen. As a result there are serious limitations in my view as to what can be achieved in a holistic sense from a compliance improvement viewpoint.
64. Significantly, all of the international research findings that I have examined over many years suggest that ***administering personal income taxes without withholding or systematic reporting and matching regimes inevitably results in significantly lower levels of compliance at the aggregate taxpayer population level—in all likelihood, no higher than 90%***. In other words, the absence of such requirements (particularly where conscious decisions have been made to exclude them from the tax system), results in what I term a '*systemic non-compliance imbalance*'—no matter what the revenue body does within the limits of the resources available to it, it is not capable of achieving overall compliance to a level exceeding 90%, or anywhere near the higher levels of compliance otherwise achievable in an overall sense. This systemic compliance imbalance has two important downsides—significant revenue leakage and inequity with those taxpayers who pay all/ the bulk of their taxes as a result of the operation of withholding and reporting mechanisms.

### *The Australian context*

65. These observations have important implications in an Australian context given that in comparison with the tax systems of most OECD countries, Australia's income tax system makes relatively limited use of both withholding and reporting mechanisms for SME/self-

- employed income. This was not always the case and in the context of this tax reform exercise and the goal of developing a blueprint for Australia's future tax system, it seems an issue worth revisiting, particularly given the significant amount of tax revenue likely to be at stake.
66. Until 2000, administration of Australia's income tax system was "protected" with the operation of both the Prescribed Payments System (PPS), introduced in 1983, and the Reportable Payments System, introduced in 1994.
67. The PPS was a withholding and reporting regime operating in a range of prescribed industries of which building and construction was the prime target. The system provided for a flat rate of withholding of 10 percent (or the top marginal rate of tax where a valid TFN was not provided by payee taxpayers), with provision for taxpayers to obtain a lower rate of withholding where they had high expenses, or an exemption from withholding on account of having a good compliance record. For the last year of its operation, total PPS collections amounted to some \$3.1 billion. For the 2000 financial year, some 420,000 non-corporate taxpayers reported around \$22 billion of PPS income in their returns (with presumably a larger amount being reported to the ATO by payers).
68. The RPS was, in the main, a reporting regime with a withholding sanction, applying to a range of prescribed payments—firstly, the fishing and clothing industries and thereafter the smash repair and fruit and vegetable industries. For the 2000 financial year, some 20,000 non-corporate taxpayers reported around \$2.5 billion of RPS income in their returns (with presumably a larger amount being reported to the ATO by payers).
69. Both the PPS and RPS systems were abolished in 2000 as part of the previous Government's reform program for reasons, I understand, associated with the objective of simplifying tax system requirements as part of the reform program's initiatives (e.g. the GST, BAS, the ABN system, and PAYGO systems).<sup>15</sup> In brief, as part of the new arrangements, withholding and reporting requirements were only to apply to a fairly limited range of business-related income payments, as follows:
- Any entity that is a payee in a business to business transaction and fails to quote an ABN;
  - Individuals providing prescribed services (i.e. performing artists, tutors, translators/ interpreters) as defined in law;
  - Individual labour-hire workers;
  - Individual contractors who enter into a voluntary agreement;
  - Services provided by non-residents for sports & entertainment, construction, & casino gambling tours; and
  - Alienated personal services payments paid by personal services entity.
70. In other words, the withholding and reporting mechanisms were intended to operate, and this remains the case, only for what can be described as 'exception' situations and/or for a relatively limited range of prescribed payment categories, unlike the prior arrangements where they operated more broadly for prescribed industries. The impacts of this are described later in this part.

---

<sup>15</sup> It is perhaps noteworthy to record that at the time these changes were made there were other countries with VAT systems that also administered special withholding and reporting regimes for prescribed categories of taxpayers (e.g. Canada, Ireland, New Zealand, and United Kingdom).

71. Table 3 hereunder provides a summary of the various categories of personal taxpayer incomes, viewed from the perspective of the level of protection afforded by the operation of withholding and reporting regimes. The purpose of this table is to demonstrate the likely extent of risk to compliance that exists in the absence of relevant withholding and reporting mechanisms.

**Table 3. Personal incomes in 2006-07: Distribution by extent of withholding and/or information reporting (by major income category)**

Income category	Income returned by taxpayers		% of income generally subject to withholding	% of income subject to information reporting laws
	Amount (bn)	% of total		
Salary, wages, allowances, ETPs	392	52	100	100
Pensions & benefits	26	4	100	100
Interest	11	1	0 /1	100
Dividends	19	2	0 /1	100
Rent (gross)	21	3	0	0
Capital gains (gross)	47	6	0	0
Total business income	102	13	0 /2	0 /2
P&T total business income /4	141	19	0/2	0/2
<b>Totals</b>	<b>759</b>	<b>100</b>	<b>56 (approx.)</b>	<b>59 (approx.)</b>

Source: Tax Statistics 2006-07

/1. Withholding and reporting required where no TFN provided by taxpayer. For 2007, these withholdings for personal taxpayers (incl. partnership and trusts (P&Ts) amounted to around \$130 million.

/2. Withholding and reporting required for certain payments where no ABN quoted and for a very limited range of prescribed payments (e.g. labour hire). For 2007, these withholdings totalled around \$250 million, representing income of no more than \$1 billion.

/3. Projects are undertaken using property sales data provided by state government real property registration bodies. However, these are not akin to comprehensive and systematic annual reporting and matching of all relevant transactions, as carried out for dividend and interest payments.

/4. P&T income is distributed to corporate entities, individual taxpayers, and others. The precise split is not clear from published data. For this analysis, it is assumed that the income of all P&Ts with annual total business income <\$2 million is distributed to individuals, while all other P&T income is distributed to other entities. This approach is likely to understate the income received by individuals for PIT purposes.

72. As evident from the data in Table 3, and taking account of highlighted shortcomings in the data available, it can be concluded that at least 40 percent of personal income is not protected in a tax compliance context by either comprehensive 'withholding at source' and/or 'information reporting' mechanisms. The significance and implications of such a gap can be viewed in the context of the following general observations and comments:
- The ATO does not (yet) attempt to quantify the likely magnitude of the overall compliance risk (resulting from all forms of non-compliance behaviour) for the relevant categories of income highlighted in Table 3, meaning that there is currently no readily available information on the likely incidence of aggregate non-compliance (and associated revenue leakage).<sup>16</sup> In other words, precise information on the likely level of overall revenue leakage from this gap is not available.

<sup>16</sup> In a speech dated 20 January 2009 to the Australian Tax Teachers Association Conference, the Commissioner of Taxation indicated that experimental work was underway to develop estimates of the tax gap for both direct and indirect taxes.

- I believe it can be argued intuitively (particularly taking account of the findings of overseas compliance research) that; 1) there is a considerable exposure to non-reporting risk given that information reporting arrangements cover no more than around 60% of personal incomes; and 2) that the amount of tax revenue at risk could be quite significant. For example:
    - if 5% of total income (in my view, a conservative estimate) that is not reportable by third parties under the law to the ATO is not disclosed voluntarily by taxpayers in their PIT returns (for whatever reason), the amount of unreported income would of the order of \$16 billion per annum; applying a figure of 10% raises the amount of unreported income to around \$32 billion.
    - the tax revenues associated with these projections, assuming a 20% average rate of tax, are roughly \$3.2 billion and \$6.4 billion respectively (or around 3 and 6 percent respectively of aggregate net personal tax collections for each year).
- (NB: Such estimates would exclude non-compliance resulting from over-claimed deductions etc., which would add to the overall incidence of non-compliance (and associated revenue leakage.)
- ATO enforcement/ audit programs “claw back” a portion of unreported personal business and other income but the amount involved is unlikely to exceed \$2-3 billion each year, based on the published results of the ATO’s compliance programs.
  - To present an international perspective on what other revenue bodies have reported as the overall incidence of non-compliance, the following information is provided:
    - the UK revenue body published a PIT net compliance gap estimate (for self-assessing taxpayers) for 2004-05 of 14 percent for 2004-05;<sup>17</sup>
    - the Swedish Tax Agency published a PIT net compliance gap estimate for 2005 of around 5 percent;<sup>18</sup> and
    - the US IRS published a PIT gross compliance gap estimate of around 21% percent for 2001 (around 1/6 of which it estimated would be clawed back by its enforcement programs).<sup>19</sup>

These findings, while arising admittedly in different jurisdictions, nevertheless give a sense of the ‘potential order of magnitude’ for non-compliance for the personal tax in Australia and suggest that the projections presented in respect of unreported income are not be beyond the bounds of reality.

- There have been a number of statements from Government bodies calling for more effective methods to deal with taxpayers’ non-compliance in the areas indicated. The Australian National Audit Office in a number of performance audits<sup>20</sup> over recent

---

<sup>17</sup> See UK HMRC’s 2008 Autumn Report (page 40).

<sup>18</sup> See Swedish Tax Agency’s ‘*Tax Gap Map*’ (February 2008), page 61. The quoted tax gap figure relates to PIT on earnings and includes tax on capital which is subject to a much higher rate of non-compliance.

<sup>19</sup> See ‘*Reducing the Federal Tax Gap*’ US IRS (August 2007, page 11).

<sup>20</sup> For example, see ‘*The ATO’s Use of Data Matching and Analytics in Tax Administration*’ ANAO (April 2008) and ‘*Administration of Capital Gains Tax Compliance in the Individuals Market Segment*’ ANAO (2006-07).

years has drawn attention to gaps in the ATO's information reporting and matching capabilities, specifically:

- Assessable government benefits (many of which are paid to business);
- Capital gains-related transactions;
- Areas of the cash economy; and
- Dividend and interest income for non-individuals.

Similarly, the Commissioner of Taxation has signalled his concern for the incidence of non-compliance in certain high risk industries and the possibility of new withholding requirements.<sup>21</sup>

73. These concerns and shortcomings raise the question of how other countries tackle such problems and what, realistically, can be done in Australia.

#### *International approaches and experience*

74. In contrast to the situation existing today in Australia, quite a number of OECD countries make use of withholding and reporting mechanisms to tax and track specific business-related income and, for some countries, there is an emerging direction of taking this much further. Table 4 hereunder sets out information concerning the use of withholding and information reporting regimes in respect of prescribed categories of business income in selected OECD countries with fairly comprehensive arrangements. With minor exception, these regimes entail the systematic reporting and matching of data with tax records using a unique taxpayer identifier. With the exception of the USA, these regimes operate in countries where a value added tax also exists while a number of regimes (e.g. those in Canada, Germany, Ireland, and UK) target industries previously within the scope of the former Prescribed Payments System.

**Table 4. Use of withholding and/or reporting regimes in respect of business-related income in selected countries**

Country	Nature of regime /1	Industries targeted	Taxpayers covered by reporting
Canada	R	Construction industry & <u>all</u> goods & services provided on contractual basis to Federal Government bodies	1.45 mln
Germany	W&R	Payments for construction work	n.avail
Ireland	R (WS)	Construction, meat processing & forestry	118, 000 (withholdings of €920 mln p.a.)
	W&R	Prescribed professional services— medical, legal, financial, training, engineering etc.	n.avail (withholdings of €500 mln p.a.)
	R	Very broad coverage prescribed in law (see Annex 1)	n.avail
Mexico	W&R		
New Zealand	W&R		
Spain	W&R		
Turkey	W&R	Fairly broad coverage prescribed in law (see Annex 1)	
UK	W&R	Construction	1 mln (withholdings of over £4 billion p.a.)
USA	R(W)S withholding	Very broad coverage prescribed in law (see Annex 1)	23.4 mln

/1. W-withholding, WS- withholding as a sanction; and R- reporting.

<sup>21</sup> See 'ATO 2008-09 Compliance Program' (page 30).

75. Drawing of OECD work in course (expected to be published in June 2009), there is a lack of quantitative information on the actual compliance impacts of the regimes in the SME/self-employed sector. However, the regimes subjected to detailed survey—Canada, Ireland, UK and USA—were generally rated by their respective revenue bodies as highly effective, an outcome that is supported compliance-related research findings for other income categories.
76. The OECD's work has also brought to light proposed developments concerning new information reporting regimes that the US intends to implement in coming years in response to serious revenue leakage in the US system, as evident from the data at paragraph 68 (4<sup>th</sup> dot point). To this end, legislation has been enacted in the USA that will substantially expand the capture of payments made to SME/self-employed taxpayers when the new requirements come into operation:
- Payments made by card payment settlement entities (e.g. credit card companies and banks) to merchants in respect of card purchases (effectively representing sales to consumers—annual reporting from 2012.
  - Payments by federal and state government bodies to business for property and services (including contracts) and certain local government payments—subject to 3% withholding and reporting beginning in 2011.

Also under consideration are certain payments to corporations in the course of a trade or business (that would complement existing reporting obligations where such payments are made to individuals).

77. Once the new reporting streams come on track, the US IRS will have the most comprehensive system of information reporting of any revenue body in the world, reflecting a strategic choice by the US Internal Revenue Service (and presumably the US Government) for technology and information as the key underpinning force for driving improvements to taxpayers' compliance. Recent comments by the IRS Commissioner reinforce this view.....

*“What these enormous transformational shifts mean is that many of the ways that the IRS has traditionally done business must change. Old operating models have gone the way of 8-track tapes and floppy discs. We have to evolve to operate in this new environment. And we have to confront it strategically. A starting point — the fulcrum for this change — is information.*

*The IRS is an information intensive organization. Data is our lifeblood. It informs all of our activities — from service to enforcement. But with an explosion of data and information brought about by the IT revolution, it's not just about getting the data but rather analysing and making the best use of it.*

*But first the “getting.” Taxpayers and the IRS share a lot of information. It could be a W-2 with wages and taxes withheld by your employer, a 1099 form showing other sources of income such as from a bank, or mutual fund or a K-1 from a limited partnership reporting each owner's share of income and certain expense items. Through this sharing, the IRS gets the same information as you do. We also get it in the same format, thereby greatly reducing opportunities for confusion and miscommunication. There are other tangible benefits.*

*We know that those taxpayers who have their taxes withheld and reported to the IRS through these third parties are the most compliant. On the other end of the scale, those operating without are the least compliant.*

*What's the lesson here? Simple — better information reporting can benefit the entire spectrum of taxpayers and boost compliance. And we've been given some new information reporting tools recently. For example, last year, Congress passed new legislation that applies to businesses that accept credit and debit cards. Starting in January 2012, at the end of the year, the bank will send an information report on credit and debit card sales to the business and to the IRS.*

*Brokerage firms will also have to file with the IRS annual information returns showing a customer's cost basis in securities transactions which will go a long way to reducing misreported capital gains.*

*Better interpretation of data also means better service to taxpayers. We can learn which taxpayers prefer which IRS channel of service and how they prepare their returns. For example, younger taxpayers who are at ease with technology prefer our electronic and self-serve options and tend to file their return electronically. On the other hand, older taxpayers and those with limited English proficiency may prefer meeting with an IRS representative in person and send in a paper return.*

*By better mining and interpreting this information, we can tailor services to taxpayers and address concerns”.*

*(Douglas Schulman, IRS Commissioner, April 13 2009, National Press Club).*

*Removing the systemic compliance imbalance—The case for reform using information and technology*

78. I believe there is significant non-compliance as a result of a failure by SME and self-employed taxpayers to properly report business-related income in the absence of systematic withholding and reporting mechanisms. Furthermore, this non-compliance at the aggregate level—which can be regarded as ‘a systemic compliance imbalance’—cannot be treated sufficiently effectively by the current suite of administrative actions. The same conclusion applies to other categories of income that are not subject to systematic withholding and/or reporting (e.g. rents and capital gains). As a result, significant tax revenues are being foregone and there is inequity with those taxpayers whose incomes are subject to more systematic tax collection methods.
79. To address this deficiency, I recommend that consideration be given to the introduction (most likely on a phased basis) of a comprehensive system of annual information reporting (supported by business and taxpayer identifiers (i.e. the ABN and TFN) and with a withholding sanction for prescribed exception situations ) covering prescribed categories of payments, for example:
- Payments by national and sub-national governments to businesses for goods and services provided (NB: The requirement to report wages paid for the services provided by employees already exists!);
  - Payments to business by national and sub-national governments of taxable benefits/ grants;
  - Business to business payments for services and goods provided (above an annual threshold)
  - Payments to agricultural producers by marketing bodies in respect of products sold/ distributed

- Payments by card processing/ settlement bodies to merchants in respect of their sales made via debit and credit cards
  - Distributions of rental payments received by managing agents on behalf of property owners;
  - Sales of real property (by state government real property);
  - Sales of securities by brokers etc.
80. Such a reporting system would be designed to take advantage of the fact that much of this information is already recorded in government and business computer systems (and this can only grow substantially into the future), while the use of taxpayer/ business identifiers for reporting purposes, an essential prerequisite for effective matching, is already well entrenched as part of GST invoicing requirements.
81. Reporting arrangements of the kind envisaged, of course, raise a number of legitimate concerns in relation to issues such as the resulting compliance burden on reporting bodies, and matters of privacy etc. Careful consideration would have to be given to these matters but, in my view, they are not insurmountable and are clearly no different to the reporting obligations on business and Governments that already exist in relation to employment and investment income.
82. Offsetting the costs and concerns of such requirements are the many benefits that would accrue in practice:
- Improved compliance (and associated significant additional tax revenues);
  - Improved equity among taxpayers—a fairer tax system; and
  - An easier to manage tax system for the ATO.
83. An additional potential benefit to be explored concerns the possible use of such third party reports to provide assistance to taxpayers' preparation of annual tax returns. Part 2 of this submission foreshadowed the development of systematic use of third party reports that could eliminate traditional tax returns for many employee-type taxpayers. Introducing new information reporting requirements for other categories of income would open up new possibilities for providing some form of assistance to business and other taxpayers. Taxpayers and tax agents have already responded very positively to the ATO's pre-filing initiatives and it would seem that their further development can only bring greater benefits to taxpayers, thereby reducing the overall burden associated with reporting obligations.

#### Part 4. Client-centred tax-transfer administration

84. Treasury's consultation paper (page 175 et seq.) raised the idea of a radically different interface for a future tax-transfer system to, in its view, shield taxpayers from complexity and simplify administration, that was described in the following terms (underlining inserted by writer) .....

A more client centered tax-transfer system could potentially involve a single interface with individuals. Under this approach, individuals might deal with government through just one organisation. This could effectively shield individuals from much of the complexity of the tax-transfer system, minimising their compliance costs.

This approach might consist of a single government agency that would administer all taxes and transfers that are relevant to individuals. Alternatively, the single interface might be a public or private institution, which intermediates between individuals and several government agencies responsible for administering different taxes and transfers. The single interface might support a single account for each individual, through which all taxes and transfer payments are administered.

The individual, their employer and other third parties could provide all relevant information to a central agency, which would determine the individual's tax liabilities and/or entitlement to transfer payments. This might be done by way of an internet-based interface with other support for people less familiar with such technology. The benefits of this approach, including policy transparency, may be further extended by linking other features to the account, such as tax and transfer calculators and financial planning tools.

The potential benefit derived from such an approach may depend on the acceptance of policy changes required to streamline and simplify the relationship between individuals and governments. A further consideration is the community acceptance of a single agency holding significant information about its clients, and whether it is possible for one agency to administer such a broad area of responsibility while maintaining service standards.

85. Drawing on all my tax administration experience, both in Australia and particularly over the last 12 years internationally, I find that this idea raises a host of issues which detract from its merit and very few to recommend it. Furthermore, I believe that there is another less risky and painless way of dealing with the issues the idea aims to address. The key concerns I have are as follows:

- It is hard to imagine an agency other than the ATO administering an integrated set of tax and transfer obligations, as suggested, given the impracticality of hiving off personal tax administration from administration of other taxes (especially those involving business). Having one agency responsible for all tax, superannuation, and transfer functions would present significant management challenges, be extremely high risk and, in my view, would be a recipe for sub-optimal performance of critical government responsibilities.
- I would be surprised if there is a significant proportion of citizens who have both regular/ ongoing tax and transfer-related interactions. Furthermore, should the tax reform exercise and other tax policy initiatives entail some base broadening measures and/or reductions in "middle class welfare" one can foresee a reduction in the extent of any overlap. Suggesting some form of integrated administration for all citizens on the grounds that a (small?) minority is impacted does not in my view provide a compelling case for integration.

- While the ATO performs highly favourably as a revenue body in comparison with its international counterparts there is potential for further improvement in the way tax and superannuation responsibilities are exercised in order to deliver better outcomes. Reports of the ANAO and IGT give some insights as to where these opportunities rest. Giving the ATO substantial additional responsibilities would constitute a major distraction for benefits that seem highly questionable.
- Tax and welfare related functions are for all intents and purposes different “businesses”, each presenting their own challenges and demands and requiring specialist management attention and staff with quite different skill sets; the Government has already experimented with placing the Child Support Agency in the ATO and subsequently abandoned the idea (although not the linkage required to access critical tax related information).
- While I am in favor of improved public sector administration the proposal has the aura of “big brother”, particularly with its notions of a single citizen account and the assembly of massive amounts of personal information on a central database, and presumably would raise strong community objections; furthermore, its pursuance may call into question other more attractive elements of the emerging reform agenda (e.g. expansion of information gathering, if supported).

86. Given the issues of complexity and simpler administration which this idea aims to address, I believe that a better approach rests with more effective use of technology and better/ more timely sharing of information between and across relevant agencies, and some policy adjustments, for example:

- The ATO has significantly accelerated its gathering of information from third parties (in particular, from employers) to support its pre-filing initiative; there does not appear any reason why transfer paying agencies could not also benefit from this improved information gathering.
- A number of countries (e.g. Denmark and New Zealand) are known to gather employee-related information from employers on a monthly basis, rather than simply in aggregated form at year-end and I understand that Denmark has arrangements that enable such information to be made generally available to government agencies with a requirement to have it; subject to greater use of technology by businesses, etc, reporting on such a frequent basis may become less of a compliance burden and could form part of new reporting requirements that could be of substantial benefit to transfer paying agencies.
- More generally, reporting by income paying bodies such as employers and financial institutions could be made available to both the ATO and authorized transfer paying agencies via a core service capability of the kind being developed for the Standard Business Reporting (SBR) initiative, thereby providing transfer paying agencies with data on a real time basis that could facilitate fundamental business process redesign.
- Adoption of new information reporting requirements as outlined in Part 3 of this submission would make a further contribution to the repository of information available for assessing entitlements to government transfers.
- Unemployment benefits could be made non-assessable for tax purposes, given they are largely paid on a “subsistence” basis; in my view, requiring taxpayers to lump such benefits with other income and taxing them at marginal rates of tax seems highly unjust and inequitable and no doubt leads to unforeseen and

unreasonable tax debt situations; making such benefits non-assessable should substantially reduce the degree of citizen tax/transfer overlap.

**Table 5. Use of withholding and/or reporting regimes in respect of business-related income in selected countries**

Country	Name of regime	Specific payments that must be subject to withholding and/or information reporting
Ireland	Professional services	The regime applies to payments for the following prescribed <b>professional</b> services: 1) medical, dental, pharmaceutical, optical, veterinary; 2) architectural, engineering, surveying and related services; 3) accounting, auditing, finance, advertising, and marketing; 4) legal services; and 5) geological services; and 6) training services on behalf of FAS.
Ireland	Third party returns	This regime requires traders (including farmers), professionals and other persons carrying on a business to automatically make third party returns in respect of the following payment categories: 1) payments for services rendered in connection with the trade, profession, business etc., whether paid on your own behalf or on behalf of someone else; 2) payments for services rendered in connection with the formation, acquisition, development or disposal of the trade or business; and 3) periodical or lump sum payments made in respect of any copyright.
Mexico	Various names	Payments to 1) individuals undertaking business activities; 2) self-employed professionals receiving payments from legal entities; and 3) individuals deriving income from leasing of real property to companies.
		Payments to primary producers who don't keep records or issues invoices.
		Information on petrol station sales (i.e. volumes and retail prices to consumers).
		Banks withhold tax on cash deposits/ purchase of cashiers' cheques > 25,000 pesos.
		System of VAT withholding
New Zealand	Schedular payments (SCH)	<p>Payers must deduct tax on schedular payments (formerly withholding payments) from payments made to self-employed contractors and to companies operating in the horticultural and viticultural industries - unless the contractor holds a current certificate of exemption from tax on schedular payments.</p> <p>There is a range of activities that are liable for tax on schedular payments. The tax rate differs according to the activity. These include: 1) Agricultural contracts for maintenance, development, or other work on farming or agricultural land; 2) Agricultural, horticultural or viticultural contracts by companies and other contractors, including supply of labour, for pruning and/or thinning of fruit trees or vines, and picking and/or packing of fruit or grapes; 3) apprentice jockeys or drivers; 4) Cleaning office, business, institution, or other premises (except residential) or cleaning or laundering plant, vehicles, furniture etc; 5) Commissions to insurance agents and sub-agents, and salespeople; 6) Company directors' (fees); 7) contracts wholly or substantially for labour only in the building industry; 8) Demonstrating goods or appliances; 9) Entertainers (New Zealand resident only) such as lecturers, presenters, participants in sporting events, and radio, television, stage and film performers; 10) Examiners (fees payable); 11) Forestry or bush work of all kinds, planting, sowing or gathering vegetables, or flax planting or cutting; 12) Freelance contributions to</p>

		newspapers, journals etc (articles, photographs, cartoons etc) or for radio; 13) television or stage productions; 14) Gardening, grass or hedge cutting, or weed or vermin destruction (for an office, business or institution) ; 15) Honoraria (including payments to mayors, chairpersons and members of councils, boards of trustees, boards, committees and official clubs or societies); 16) Modelling; 17) Non-resident contractor companies; 18) Non-resident entertainers and professional sportspeople visiting New Zealand; 19) Payments for caretaking or acting as a watchman, mail contracting, milk delivery, refuse removal, street or road cleaning, and transport of school children; 20) Proceeds from sales of eels (not retail sales), greenstone (not retail sales), sphagnum moss (not retail sales), whitebait (not retail sales) and wild deer, pigs or goats or parts of these animals; 21) sharefishing (on contract for the supply of labour only) ; 22) Shearing or droving; 23) Television, video or film: on-set and off-set production processes (New Zealand residents only); 24) A personal service rehabilitation payment for a person under the Injury Prevention, Rehabilitation, and Compensation Act 2001;
Spain	Various names	Payments between businesses where the aggregated annual amount exceeds €3,000 /payee business operator.
		Payments for 1) professional services; 2) agricultural, stockbreeding & forestry activities; 3) certain activities taxed on lump sum schemes; 4) rents from urban real estate; & 5) rights to use personal image
Turkey	Various names	Payments by contractors to sub-contractors for long term (> 1 year) construction & repair
		Prescribed agricultural payments for farmers not exceeding specific business sizes /6
		Prescribed range of professional services payments
		Business to business payments (for VAT administration only)
United Kingdom	Construction industry scheme (CIS)	The CIS is a <u>monthly</u> withholding and reporting regime, for contractors in the construction industry. A contractor may be a construction company and building firm, as well as a Government department or local authority and other businesses known in the industry as 'clients'. Non-construction businesses or other concerns are treated as contractors if their average annual expenditure on construction operations over a period of 3 years is £1 million or more.
United States	Information returns program	Business income-related transactions that must be reported include: 1. Payments (over \$600) for services performed for a trade or business by <u>persons</u> not treated as its employees. 2. Payments of \$5,000 or more of consumer products to a person on a buy-sell, deposit-commission, or other commission basis for resale (by the buyer or any other person) anywhere other than in a permanent retail establishment. 3. Payments (over \$600) to a physician, physician's corporation, or other supplier of health or medical services. Issued mainly by medical assistance programs or health and accident insurance plans. 4. Payments to crew-members by owners or operators of fishing boats including payments of proceed from sale of catch. 5. Crop insurance proceeds of \$600 or more paid to farmers by insurance companies. 6. Gross proceeds paid to an attorney in connection with legal services (regardless of whether the services are performed for the payer).