

The Secretariat,  
Standing Committee on Tax and Revenue  
Parliament House  
Canberra ACT

9 February 2017

Dear Sir/ Madam

Enclosed is a copy of my submission dealing with the Committee's Inquiry into Taxpayer Engagement with the Tax System. I am happy to be contacted by phone or email if there are any questions.

Yours sincerely

Richard Highfield

## Standing Committee on Tax and Revenue—Inquiry on Taxpayer Engagement

### Submission by Richard Highfield <sup>1</sup>

This submission is made in response to the Committee’s notification of its inquiry and its invitation to individuals and organisations to provide their opinions and proposals. It aims to address the inquiry’s terms of reference and, in particular, the included framing questions and issues.

#### Summary of Key Findings and Suggestions for Reform

- The current modes of taxpayer engagement, in particular for individual income taxpayers with relatively simple tax affairs, are excessively burdensome and costly for them and the community at large, and are likely to be also contributing to revenue leakage.
- Far too many individual taxpayers engage late or not at all, with negative consequences for the efficient functioning of the tax system.
- Drawing on the findings and recommendations of past reviews and overseas practices, there is a variety of opportunities for reform with potential to deliver significant benefits for government and citizens.

#### A. Current modes of taxpayer engagement

##### Framing questions and issues:

*How do taxpayers currently engage?*

- What do taxpayers perceive they need to do (or think they need to do) to comply with their obligations? What informs these views?
- How do different taxpayers manage their affairs? Do they choose to engage tax advisers and other intermediaries and, if so, what are their reasons for doing so?
- Are there any broader trends emerging from specific taxpayer experiences?

This submission is confined largely to the individual income tax system and to particular aspects of how taxpayers engage or choose not to. After a brief introduction, the aspects addressed are:

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- 1) Arrangements for the collection of tax.
- 2) Annual tax returns.
- 3) Deductions for work-related expenses (WRE).
- 4) Refund churn.
- 5) Failures to engage, including participation in the so-called 'cash economy'.
- 6) The tax compliance costs of taxpayers.

## **Introduction**

Modern tax systems and their administration are built on the principle of “voluntary compliance” – taxpayers are expected to comply voluntarily with their tax obligations with only limited intervention by tax officials. In practice, voluntary compliance is achieved through what are termed “self-assessment” procedures. Under self-assessment, taxpayers are expected to calculate their own liabilities, submit their own returns and payments, and provide further information when requested. To encourage high levels of voluntary compliance, the conventional wisdom is that tax bodies should provide an extensive array of education and assistance-related products and services to help taxpayers meet their obligations with minimal burden and costs. Tax bodies also conduct risk-based programs of verification and enforcement to detect and deter non-compliance. The tax laws also provide for the imposition of sanctions (e.g. penalties and interest) to encourage voluntary compliance and to punish those who are found to have not complied.

### **1) The collection of individuals income tax**

Under existing tax law all individual taxpayers in Australia, including all employees, are generally required to lodge an annual tax return. However, for most taxpayers their engagement with the tax system typically commences earlier in a fiscal year:

- 1) As an employee, tax is withheld at source by their employer under the PAYG withholding regime; and/or
- 2) Where they derive income from sources other than employment, they are under an obligation to make advance payments of tax, either quarterly or annually, under the PAYG instalment regime arrangements.

Under both regimes, the tax paid in advance by taxpayers for the fiscal year is generally intended to be an approximation of their final assessed tax liability. It is not until an annual tax return is lodged and processed that a precise assessment is made of each taxpayer’s final liability and advised to them.

### ***PAYG Withholding***

Australia, like just about all advanced economies, relies on the use of withholding at source arrangements to collect individual income tax on employment income. There is considerable international experience that draws attention to the superiority of collecting income tax in this way. As observed by the OECD<sup>2</sup>;

*“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 to taxpayers: 1) significantly reduces, if not eliminates, their ability to understate such income for tax assessment purposes; 2) is a more cost efficient way for both taxpayers and the revenue body to*

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<sup>2</sup> Tax Administration 2015, OECD Paris 2016, p. 297.

*transact the payment of taxes; and 3) reduces the incidence of unpaid taxes that might otherwise arise where taxpayers correctly report their income but are unable to pay all of the tax assessed.*

*Published research findings of selected revenue bodies (Swedish Tax Agency, 2008, United Kingdom HMRC, 2014; United States IRS, 2012) provide strong evidence of the substantial compliance benefits from withholding. Furthermore, the timely remittance of amounts withheld by employers to the revenue body ensures a regular flow of revenue to Government, thereby assisting budgetary management.”*

The form of withholding on employment income adopted under Australian tax law is what the OECD terms ‘non-cumulative’. The alternate form of withholding is termed ‘cumulative’. The differences between the two forms of withholding are described in Annex 1. It will suffice here to say that a non-cumulative form of withholding is considerably simpler for employees and employers to administer during the course of a fiscal year. However, it typically requires an annual reconciliation with all taxpayers in the form of an annual tax return to determine their final tax liability and the amount of any tax refundable or payable.

Australia, Canada, and the United States are examples of countries which adopt a non-cumulative form of withholding and require a traditional tax return at year-end; other countries (e.g. Denmark, Norway, and Sweden) also employ non-cumulative withholding but have established systems whereby the end-year reconciliation process is fully automated, with the vast majority of taxpayers receiving a fully-completed statement of their tax affairs from the tax body.

Cumulative forms of withholding are adopted in countries such as Ireland, New Zealand and the United Kingdom, generally freeing the majority of taxpayers from the obligation to prepare and lodge a tax return<sup>3</sup>. More is said on these aspects later in this submission.

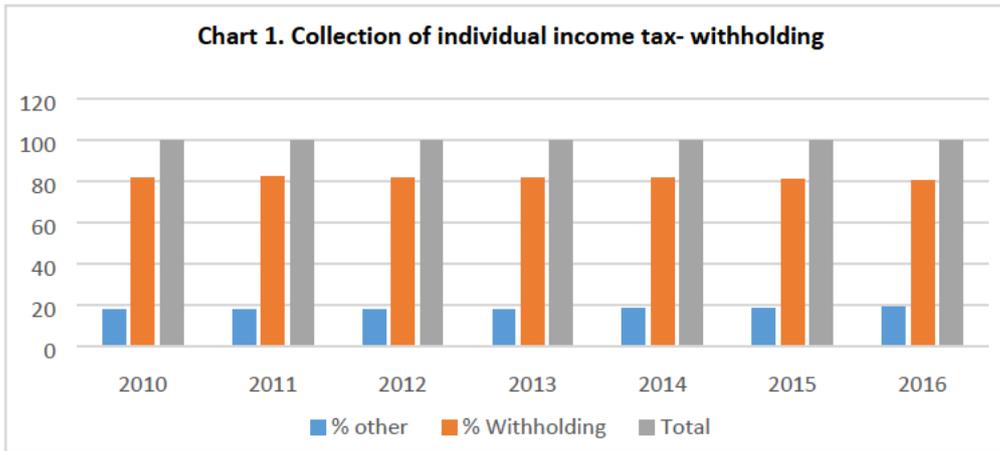
***The collection on personal income tax via withholding at source can also be applied to other categories of income (e.g. interest and dividends) although this is not generally the case in Australia.***

In its comparative series publication the OECD observes that well over two thirds of the 55 countries it surveys generally apply withholding to interest and dividend income paid to resident taxpayers. Finland, Japan, Korea, and the United Kingdom are examples of countries where this is the case. ***In addition, almost 50% of countries apply withholding at source to some prescribed categories of business/ self-employment income (e.g. Ireland and the United Kingdom).*** Australia abolished its Prescribed Payments System which applied such arrangements to certain payments when introducing the Goods and Services Tax (GST) in 2000.

The data in Chart 1 reveals the extent of the reliance on the PAYG withholding regime to collect individual income tax in Australia—over the fiscal years 2010 to 2016 the proportion of personal income taxes remitted via the PAYG withholding regime has been in the region of 80-82 percent of gross individual income taxes collected.

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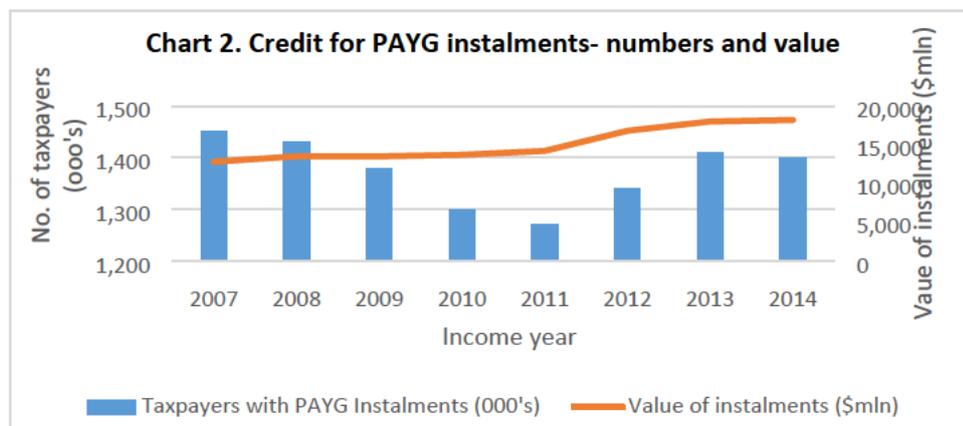
<sup>3</sup> Over the last two years, Her Majesty’s Revenue and Customs has implemented a process whereby employee taxpayers who are not required to prepare and file a tax return now receive a personal tax summary from HMRC during the following year. The statement draws on third party acquired by HMRC and seeks to formalise taxpayers’ engagement with the tax system and to improve the transparency of the UK personal tax system.



Source: ATO Annual Reports.

### ***PAYG instalments (individuals)***

The PAYG instalment (individuals) scheme aims to collect income tax on a progressive basis on income from sources other than employment. As such, it complements the PAYG withholding regime and together both regimes are intended to ensure that tax is paid on income as it is derived and that the bulk of income tax is collected within the year of income. Chart 2 hereunder displays the numbers of taxpayers credited with instalment payments and their value for each of the eight income years up to 2013-14<sup>4</sup>. As will be apparent, the overall value of instalments credited for each income year over the period grew in aggregate by around 33 percent—from \$12,800 million to \$18,200 million. **However, there was no overall growth in the number of instalment payers.** This matter is explored later in this submission.



Source: Taxation Statistics 2013-14

## ***2) The annual tax return and assessments***

Under the income tax law, taxpayers are generally required to lodge their personal tax return by 31 October, four months after the end of the income year. Tax agents are generally given substantially longer periods to lodge returns (without penalty) provided certain conditions are fulfilled, ranging up to around 9/10 months after the end of the income year. Under the tax agent lodgement program arrangements, agents are under an administrative obligation to lodge their clients' returns on a

<sup>4</sup> The data used in the chart was obtained from Taxation Statistics 2013-14 and refers to the numbers of personal taxpayers with PAYG instalment credit in their tax assessment for the years indicated, and the value of the instalment credit. The underlying data for recent years, especially the 2014 year, will grow marginally as further late-lodged returns are processed.

progressive basis and compliance with this obligation is monitored by the ATO. Returns lodged by tax agents after the final due date for lodgement are expected to be accompanied by a payment of the estimated tax due.

The timely lodgement of tax returns is important to the proper collection of tax revenue and student loan debts (under the HELP regime) and the gathering of taxpayers' data that is critical to a variety of government needs (e.g. validating payments of family tax benefits and other benefits). The income tax law provides penalties for late lodgement. However, these are generally not applied in situations where the taxpayer receives a refund of tax overpaid as a result of either excess PAYG withholdings and/or advance payments of tax.

The ATO has made considerable investments over many years to assist individual taxpayers prepare and lodge their own personal tax returns. In addition to the provision of considerable guidance on technical matters, this assistance has included over the last decade the development of a comprehensive tax return "pre-filing" capability.

Historically, the ATO matched large volumes of third party data (e.g. employment income, dividends and interest) with taxpayers' returns after they had been processed to detect potential understatements of income. With pre-filing, the range of third party data used has been expanded and, importantly, is now made available to taxpayers as they prepare their returns using the ATO's electronic filing system or tax agents' electronic filing software. The use of pre-filing has grown significantly across advanced economies over the last decade due to its considerable value in helping taxpayers to accurately report details of their tax affairs, thereby reducing the incidence of errors.

For the 2013-14 income year, the ATO upgraded its system for prefilling and electronic filing with a new product known as MyTax. From all accounts<sup>5</sup>, the MyTax application represented a major step forward in simplifying the process for tax return completion and over one million taxpayers used it in 2014-15. However, despite this initiative the proportion of taxpayers choosing to engage a tax professional to complete their 2013-14 tax return increased, continuing the trend of prior years (see Chart 3). Data for 2015 and 2016 are not yet available. Australia's use of tax agents is one of the highest among OECD countries.

The study into Australia's future tax system made numerous observations on the complexity and compliance costs arising with Australia's tax system, in particular as they relate to personal deductions and the extensive use of tax agents. For example, it observed;

*"Many people find the personal income tax system complex, not only because of the rates scale and the lack of a coherent definition of taxable income, but also because they must deal with a large set of complex deduction rules, numerous tax offsets and different forms of exempt income.*

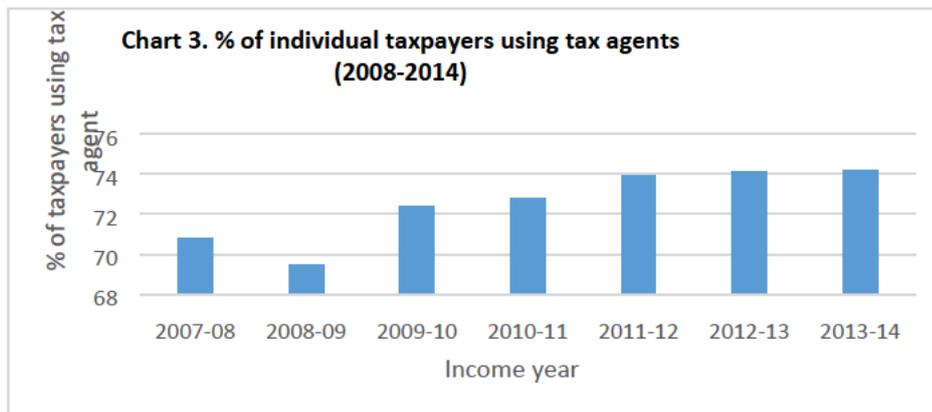
*A consequence of this is that the system is not transparent to taxpayers. It can be difficult for taxpayers to have a sense of their taxable income because of the complex rules associated with deductions, which are claimed by 80 per cent of personal income tax-filers. A common response to this and other forms of complexity in the tax system is to seek advice from a tax agent. Around three quarters of tax-filers seek such assistance. Nonetheless, in 2007-08, 86 per cent either claimed no deductions at all or only claimed work-related expenses, gifts and the costs of managing tax affairs. This suggests that the system is too complex and the compliance burden too high (AFTS, Vol 1, page 6).*

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<sup>5</sup> For example, see ATO Annual Report 2013-14, page 11.

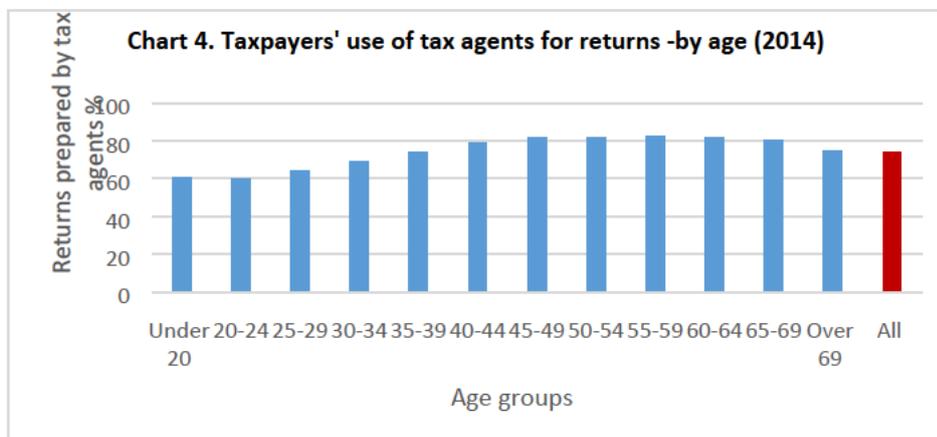
Since the tabling of the AFTS report in 2010, little has changed to the tax law that would ease the burden on taxpayers and their compliance costs and the arguments for the major reforms that were recommended then are no less relevant today. For example, using ATO statistical tabulations and selective analysis of taxpayer records from the ATO Sample File<sup>6</sup> for the 2013-14 income year, the following observations are highly pertinent:

- **Tax agent usage has grown:** The use of tax agents by personal taxpayers grew in the five years up to 2013-14, reaching 74.2 percent for 2013-14 (see Chart 3).



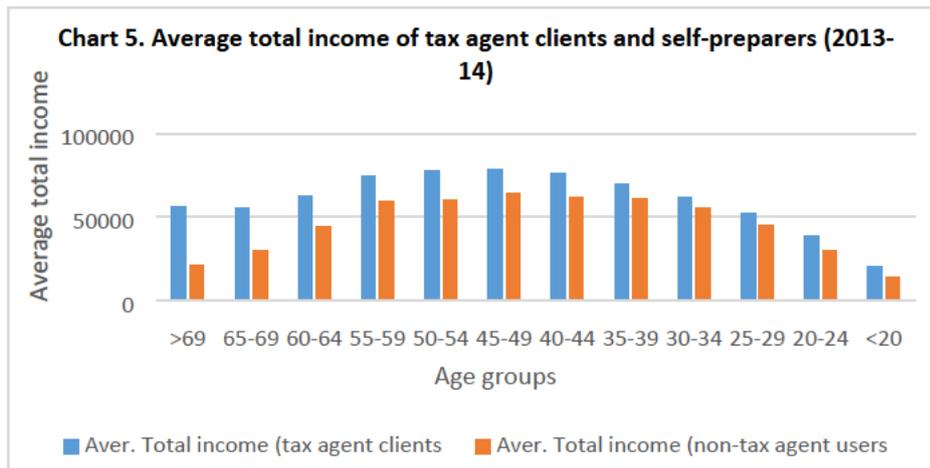
Source: ATO Taxation Statistics 2013-14

- **Tax agent usage among individuals rises with age and income:** Tax agent usage is highest among taxpayers aged between 40 to 65 years, reaching a peak of 82.6 percent among taxpayers aged 55-59 (see Charts 4 and 5).



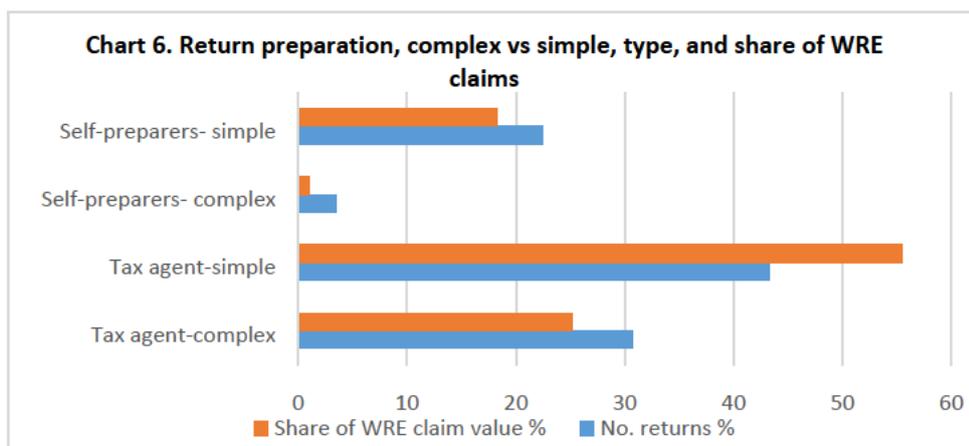
Source: ATO Sample File 2013-14.

<sup>6</sup> The ATO makes available each year a statistical file of anonymised individuals' tax return records —the Individual Sample File—for external research purposes. For 2013-14, the file contained unit record data for 2 percent of all income tax returns processed, representing just over 258,000 taxpayers. The file provides a statistically representative sample of tax returns processed. Each tax return record included in the sample contains an extensive array of demographic, income, deductions, and other relevant data (e.g. tax agent vs self-preparers).



Source: ATO Sample File 2013-14.

- The majority of personal tax returns (i.e. both tax agent and self-preparers) are relatively straightforward:** Classifying all taxpayer return records into two broad categories of ‘complex’ and ‘simple’<sup>7</sup>, around 66 percent of taxpayers (i.e. around 8.5 million taxpayers) fall into the ‘simple’ category (see Chart 6). This population of taxpayers with ‘simple’ tax affairs includes over 650,000 citizens aged over 65 years—with over 60 percent engaging a tax agent—a number that can only grow in coming years as the overall population ages.



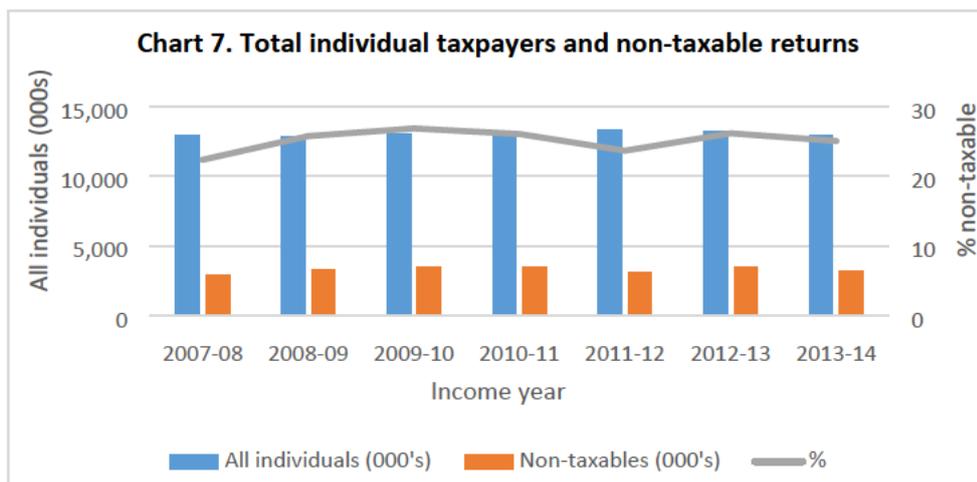
Source: ATO Sample File 2013-14.

- Tax agent usage is significant among taxpayers with relatively straightforward tax affairs and appears driven largely by a desire to maximise claims for deductions, in particular work-related expenses:** Analysing records in the ATO’s Sample File, approximately 59 percent of tax agent-prepared returns (representing around 5.6 million taxpayers) disclose income only from employment, pensions, and investments. In other words, these returns are free of the complexity and underlying detailed records necessary for determining taxable income from sources such as rental properties, capital gains, and/or business/self-employment (including partnerships and trusts), and just about all of the income of these taxpayers can be pre-filled by the ATO. Further examination of Sample File records reveals that for these taxpayers their deduction claims are concentrated on work-related expenses (81 percent), gifts (5 percent),

<sup>7</sup> The categories are: 1) Complex (i.e. tax return records with business/ self-employment income, partnership and trust income, rental income, and/or capital gains); and 2) Simple (i.e. tax return records without the features of ‘complex’ tax return records).

and tax agent fees (6 percent). *Clearly, deductions for work-related expenses are the predominant reason why these taxpayers engage tax agents.*

- **Large numbers of individuals tax returns generate no tax or very little:** The proportion of tax returns assessed that generate no tax (i.e. are assessed non-taxable) was, on average, approximately 25 percent in the seven years up to 2013-14 (see Chart 7).



Source: Taxation Statistics 2013-14

In a previous submission to the Government’s RETHINK tax reform project, this writer made a number of additional observations, drawing on an analysis of tax return records for 2012-13:

- Non-taxable returns are predominantly lodged by salary and wage earners (e.g. casual income and part-time workers) and citizens with small amounts of investment income; over one third of these citizens engage a tax agent, incurring additional compliance costs which for some cannot be offset with a tax benefit (i.e. deductibility for tax purposes).
- Around 44 percent of all tax returns were received from citizens with taxable income below \$37,000, generating relatively little tax (i.e. around 2.8 percent of total net tax); over 30 percent of these citizens engaged the services of a tax agent.
- Assuming a modest compliance cost of \$400 for all of the returns received with a taxable income below \$37,000, the annual compliance costs would have exceeded \$2 billion, a significant amount when viewed in an overall tax system and community context.

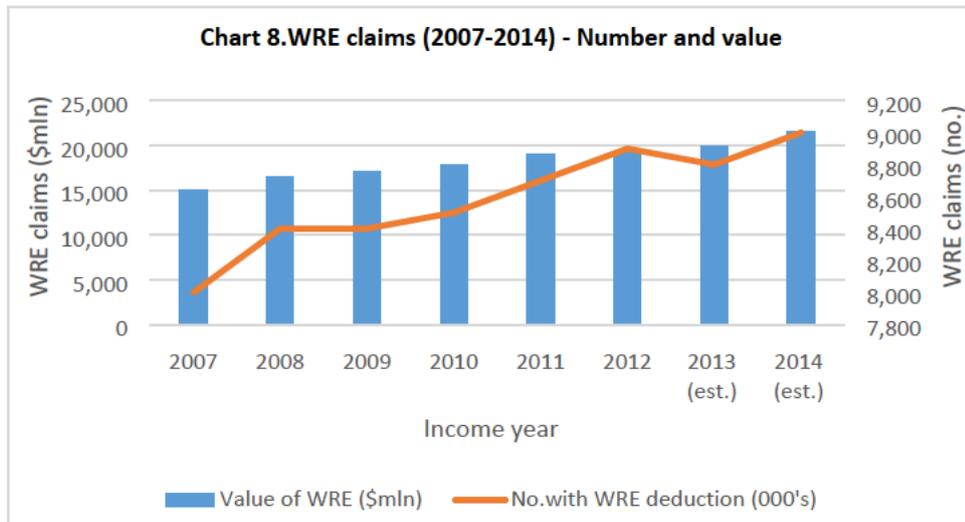
In my view, simpler and far less costly processes should be devised for these ‘high volume/ low value’ taxpayers.

### **3) Deductions for work-related expenses**

Under the tax law, personal taxpayers are able to claim tax deductions for a broad range of work-related expenses where they are incurred in deriving assessable income. These include expenses for motor vehicle and travel, uniforms, tools of trade, self-education and a large variety of other items. Some expenses have both a work and private component and in such cases the expenditure must be apportioned; only the work-related element can be claimed as a deduction.

Drawing on analyses of published data and the ATO’s Sample File it is possible to identify a number of trends in the incidence and nature of WRE deductions. The key points are as follows:

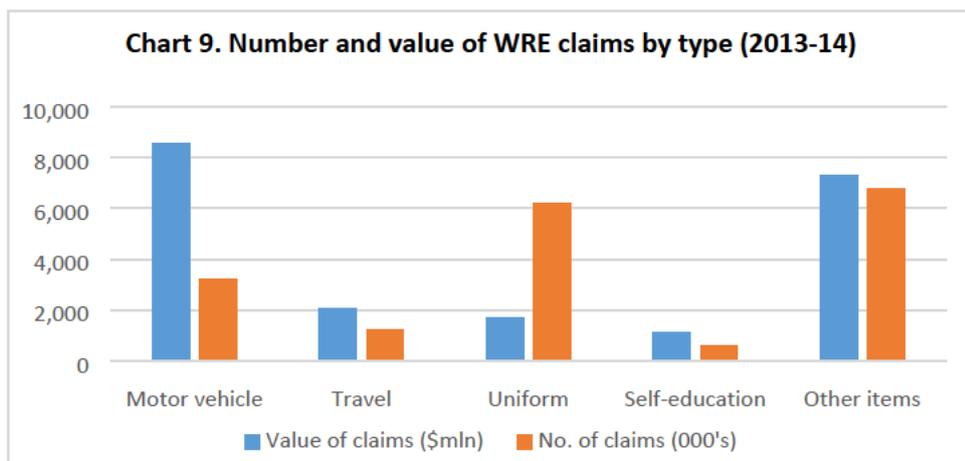
- **Aggregate WRE claims, both in number and value, continue to grow:** Once the vast bulk of returns are processed, total WRE deduction claims for 2013-14 are likely to be of the order of \$21.5 billion, on behalf of just under 9 million taxpayers (see Chart 8).



Source: ATO Taxation Statistics 2013-14 and writer's estimates for 2013 and 2014.

Projecting to the current year on historical growth rates, total claims for 2016-17 are likely to reach between \$24-25 billion, on behalf of over 9 million taxpayers.

- For taxpayers with taxable incomes between \$37,000-150,000, the incidence of WRE claims among taxpayers reporting wage income exceeds 90 percent; on average, WRE claims rise with taxpayers' income.
- Around 3.3 million wage earners made WRE claims for motor vehicle expenses amounting to over \$8.5 billion for 2013-14, despite the fact that travel expenses to and from an employees' workplace are generally deemed private for tax purposes and are therefore non-deductible (Chart 9 refers); while many employees can justifiably point to the legitimate use of their motor vehicles for work purposes, it is extremely difficult to comprehend how this population could extend to anywhere near 30 percent of the total employee population.



Source: Taxation Statistics 2013-14

- While significant in both the volume of claims and the proportion of employee taxpayers making such claims, the overall value of WRE deductions is relatively quite small, representing only around 3.6 percent of gross wage income received; in my view, the sheer volume of

claims coupled with the overall costs incurred by taxpayers and the ATO in preparing and processing these claims, and associated revenue leakage (see later comments), provides justification for major rationalisation of this aspect of the individuals income tax system.

*Reform of WREs is long overdue given the compliance burden they create and the likely revenue leakage involved*

The AFTS study report also drew attention to the issue of revenue leakage resulting from over-claimed deductions for work-related expenses, noting:

*“There is a high degree of variation in WRE claims among individuals with identical occupations and income levels. This variability could be explained by: some taxpayers over-claiming (including expenses that might be private, domestic or capital in nature), given the limited ability of the ATO to audit WREs; some taxpayers interpreting expenses that are incurred in performing their job differently from other taxpayers (raising issues of complexity and transparency in the system); and differences in employer behaviour, where some employers pay for a particular type of expense while other employers do not.*

*In Canada, a country with a similar tax system and administrative arrangements to Australia, it is estimated that 10 to 15 per cent of WRE claims each year are invalid. If over-claims in Australia are of a similar order, this would equate to an over-claim of between \$1.4 and \$2.1 billion in 2006–07. While no tax system can achieve perfect compliance, the potential magnitude of non-compliance suggests that administrative solutions alone cannot address this issue (Highfield 2009).” (Vol.1, Personal Tax, page 55)*

It is not possible to provide an indication of the likely extent of revenue leakage associated with over-claimed WRE deductions for recent years. The ATO does not publish compliance-related data on the incidence of over-claimed WRE deductions although its reports (e.g. historical compliance programs) and media statements over many years have consistently drawn attention to the ongoing non-compliance issues in this area.<sup>8</sup> Applying the rates referred to in the AFTS study, over-claimed WRE deductions of 10-15 percent for the 2016-17 income year would amount to between \$2.5-3.7 billion, representing around \$750-\$1,200 million of foregone revenue. In my view, annual revenue leakage of this magnitude (or greater), should it be occurring, would justify a swift and comprehensive response.

In the absence of substantive reforms, the issues raised in the AFTS study report are no less relevant in 2017. Of particular concern to me are the compliance costs being incurred, the likely incidence of revenue leakage resulting from undetected over-claimed WRE deductions, and the fact that a strategy to transform this aspect of tax administration, drawing on practices observed elsewhere, has long been identified but largely not acted upon. Ideas for reform are set out later in this submission.

#### **4) Refund churn**

A somewhat perverse feature of Australia’s tax system is the high incidence of overpaid taxes that must be refunded to taxpayers, sometimes referred to as ‘refund churn’. Overpaid taxes constitute a compliance cost to taxpayers and present a significant threat to the ATO and individual taxpayers in the form of the incentive they create for refund fraud. In short, the higher the incidence of overpaid

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<sup>8</sup> The ATO currently has a tax gap research program underway and has committed to completing tax gap estimates for all taxes, including income tax. Some have already been published. The tax gap research concerning income tax may shed some light on the incidence of over-claimed WRE deductions.

taxes (and in the absence of interest to compensate), the larger compliance costs incurred by taxpayers and the incentives for refund fraud.

Over the five year period 2011-12 to 2015-16, the ATO refunded on average around 23 percent of the total gross revenue collections, approximately \$96 billion each year. By international standards, this incidence of refunds is above the OECD average (i.e. 20.7 percent for the countries reported)<sup>9</sup>.

In the Australian context, over 50 percent of the taxes refunded arise with the Goods and Services Tax (GST). Such a high level of refunds is quite common in advanced economies operating with a broad-based goods and services tax, and results largely from the high volumes of exported goods and services that are made GST-free.

Concerning the collection of individual income tax and associated refunds, the combination of a PAYG withholding rate scale that is calibrated to slightly over-withhold taxes collected at source by employers and a fairly high incidence of tax deductions in annual tax returns contributes to what is a relative high level of personal income tax refunds. As indicated in Chart 10, refunds of personal taxes averaged almost 14 percent of gross personal tax collections over the period 2013-2016. To put this in an international context, this level of refunds is below that observed in the United States where the tax system has certain features similar to those seen in Australia (e.g. non-cumulative withholding, universal filing, and tax deductions) but is fairly higher than the level observed in countries such as New Zealand, the United Kingdom and Ireland (see Chart 10). In each of these countries, the tax system adopts a cumulative form of withholding for employment income, there are strict limits on employees' work-related deductions, and the vast majority of individuals are not required to prepare and file an individual tax return—around 65 percent in both New Zealand and the United Kingdom.



Sources: Australia- ATO Annual Report 2015-16, Ireland- Revenue Annual Reports, NZ- IR Annual Reports (2016 & 2014); UK-HMRC Statistics 2016, and USA- IRS Data Books.

In practical terms, a high incidence of tax refunds present major challenges for the ATO. Taxpayers' expectations of rapid refunds coupled with formal service delivery standards mean that the ATO is under considerable pressure to process and validate returns quickly, to detect cases of potential refund fraud before those refunds are made, and to make legitimate refunds of taxes overpaid expeditiously. The high volume of cases involved—see Table 1—means that on an average working day in the region of 7,500 tax returns involving potential refunds in excess of \$4,000 must be processed by the ATO. When other taxes (e.g. GST) are taken account of, the number is even higher.

<sup>9</sup> Tax Administration 2015, OECD, page 209. For 2013, the OECD reports the following incidence of tax refunds: Australia- 23.8%, Canada- 22.1%, Japan-13.2%, New Zealand-17.9%, United Kingdom-16.5%, and United States - 12.8%. The relatively low rate for the USA is influenced by the absence of a GST/VAT.

In an environment of increasing instances of identity theft, significant volumes of high value refunds and pressures to make such refunds quickly, the prospects for refund fraud are heightened.

**Table 1. Number of individual income tax refunds (2011, 2012, and 2013)**

Refund size	2010-11 (000's)	2011-12 (000's)	2012-13 (000's)
Refund over \$10,000	259	300	304
Refund \$8,000- 9,999	159	178	209
Refund \$6,000- 7,999	353	388	469
Refund \$4,000- 5,999	832	834	824
Refund \$2,000- 3,999	2,225	2,052	2,025
Refund \$1- 1,999	6,566	6,534	6,431
<b>Total refunds (000's)</b>	<b>10,394</b>	<b>10,286</b>	<b>10,262</b>
<b>Total value of refunds (\$bn)</b>	<b>24.9</b>	<b>25.3</b>	<b>25.8</b>
<b>Average value of refund (\$)</b>	<b>2,395</b>	<b>2,460</b>	<b>2,514</b>

Source: Taxation Statistics 2013, Table 16 summary table.

***Globally, tax regimes characterised by a high incidence of refunds are proving to be an attractive target for fraudsters, sometimes involving criminal gangs, who through various means (very often involving identity theft or fictitious taxpayer registrations) seek to defraud governments of revenue.***

In my view, there are compelling reasons to significantly reduce the value of individual tax refunds where it is feasible and safe to do so. Ideas for achieving this are set out later in this submission.

#### **5) Failures with taxpayer engagement**

***Too many citizens are not engaging as required.*** This applies particularly in relation to obligations under the income tax law to lodge returns on-time (i.e. by the due date specified in the law, or as per any approved arrangement for a longer period), and the obligation to pay taxes due on time.

##### *On-time lodgement of returns*

Compliance with on-time return lodgement obligations is monitored by the ATO and is a key performance measure reflected in its annual corporate plan and Parliamentary Budget Statement. The ATO provides an account of on-time lodgement performance in its annual reports (see Table 2 below).

**Table 2. On-time lodgement performance for income tax returns by entity type (2011-15)**

	2010-11	2011-12	2012-13	2013-14	2014-15
Individual	79.9%	82.0%	82.4%	82.7%	83.0%
Company	71.3%	73.7%	74.2%	75.4%	75.6%
Trust	68.3%	80.5%	80.1%	81.6%	79.9%
Super Fund	77.4%	79.5%	79.8%	79.2%	79.0%
Partnership	77.0%	80.6%	80.3%	84.7%	83.1%
<b>TOTAL</b>	<b>78.8%</b>	<b>81.4%</b>	<b>81.7%</b>	<b>82.2%</b>	<b>82.3%</b>

Source: Australian Taxation Office Annual Report 2015-16, page 36.

As reported in Table 1, 83 percent of individual taxpayers, including those using tax agents, lodged their 2014-15 tax return “on-time” while 17 percent did not. The measured rate of performance over the five years reported reflects a trend of improved on-time lodgement compliance. However, drawing on the explanations provided by the ATO in its annual reports ***it will be seen that its measure of on-time lodgement is constructed having regard only to the population of returns lodged within 12 months of the end of relevant income year.*** As a result, the computation excludes all returns lodged more than 12 months after the end of the relevant income year which, with very minor exception, would be all lodged “late” under the income tax law. Drawing on ATO statistical tabulations, the

number of personal tax returns lodged more than 12 months after the end of the income year is likely to be at least 700,000 meaning that the actual incidence of on-time lodgement (where returns are actually lodged) is likely to be closer to around 75 percent. When account is also taken of the fact that some citizens with an obligation to lodge do not comply at all the true rate of on-time lodgement is unlikely to exceed 70.0 percent<sup>10</sup>. Even allowing for the fact that many of the taxpayers lodging their returns late will have in all likelihood paid some/all of their tax in advance (either by employer withholding or instalments), an overall rate of late lodgement of 30 percent is in my view unacceptably high for an advanced economy and is inconsistent with the fundamental objective underpinning Australia’s tax system—achieving high levels of voluntary compliance. Clearly, the current (and long entrenched processes) for achieving voluntary compliance in relation to on-time return lodgement are not working effectively and require reform.

### *On-time payment of taxes*

Compliance with on-time payment of tax obligations is monitored closely by the ATO and is a key performance measure reflected in its annual corporate plan and Parliamentary Budget Statement. The ATO provides an account of on-time payment of taxes in its annual reports (see Table 3 below).

**Table 3. On-time payment of taxes- 2011-12 to 2015-16**

Performance criterion	Criterion source	Years				
		2011-12	2012-13	2013-14	2014-15	2015-16
Payment- proportion of liabilities paid on time by value	Corporate Plan/ PBS					
<b>Total</b>		89.1%	89.1%	88.6%	89.2%	89.5%
• Pay as you go- PAYG withholding		95.1%	95.2%	95.3%	95.0%	94.9%
• Individuals- returns & instalments		70.1%	69.5%	68.5%	69.1%	69.4%
• Companies- returns & instalments		86.7%	86.3%	84.9%	86.0%	87.2%
• Goods & Services Tax		87.6%	87.5%	87.8%	87.8%	89.5%
• Excise		94.2%	94.7%	96.0%	96.8%	93.1%
• Superannuation funds- returns & instalments		-	-	-	-	93.6%

Sources: Australian Taxation Office Annual Reports 2012-13 and 2015-16.

As indicated in Table 3, around 90 percent of all assessed and declared taxes are paid on time. Based on my experience working in collaboration with tax bodies in many advanced economies, this overall rate of on-time payment compliance reflects a good standard of voluntary compliance. However, as also evident from the information set out in Table 2 ***the on-time collection of individuals income tax through instalments and the return assessment process is at levels substantially below that of all other taxes over the period five year period reported***, suggesting possible systemic shortcomings in

<sup>10</sup> Details of a study examining the overall incidence of income tax return non-lodgement can be found in the report ‘*Review into the non-lodgement of individual income tax returns*’, Inspector General of Taxation, (2009). The study, conducted in collaboration with the ATO, concluded that the number of non-lodged individual tax returns in any year can conservatively be estimated at between 1.2-1.5 million (around 9-10 percent of the total estimated population liable to lodge a tax return). When full allowance is made for returns lodged late (after the period covered by the IGT’s study), I estimated in 2013 that the proportion of citizens who should lodge but never do is likely to be closer to around 6 percent. (see *Does the Australian Higher Education Loan Program (HELP) undermine personal income tax integrity?* Highfield and Warren, 2014). There are no signs that this situation has changed in any significant way.

either the PAYG withholding regime and/or the income tax instalment mechanism. With total collections of personal income tax other than PAYG withholdings amounting to \$41.7 billion in 2015-16, the amount of tax paid late is significant.

In addition to representing a major compliance issue, the failure by taxpayers to pay income taxes on time raises the important issue of “equity among taxpayers”. The vast majority of income taxpayers, being employees, have no choice when they pay their taxes—they pay in advance through their employer under the PAYG withholding regime.

I am not aware of the precise reasons for such a high rate of late payment of individual income tax (excluding withholdings) when other taxes are reported as performing well. However, as noted earlier in this submission there has been no net growth over the last eight years in the overall numbers of instalment payers, pointing to possible policy design shortcomings with the PAYG instalment regime. An additional consideration is whether greater use of withholding at source should be made for collecting individuals’ income tax given its proven superiority in achieving high levels of compliance.

### *Taxing issues associated with the cash economy*

The so-called ‘cash economy’ is an important area of tax non-compliance for the ATO and other arms of government and requires close monitoring and a comprehensive strategy to curtail its impacts.

Unfortunately, there appears to be a considerable amount of confusion in the media and elsewhere in Australia as to just exactly what types of behaviours in a tax compliance context comprise this phenomenon. This confusion is exacerbated when different arms of government use different terminology when referencing this matter—for example, the terms ‘cash’, ‘black’, ‘hidden’ and ‘shadow’ economy have all recently appeared in the media, often without a clear explanation of what each term was intended to mean.

Largely for government statistical purposes, the OECD adopts the term ‘the non-observed’ economy to represent all economic activity that goes unreported (for a variety of reasons) in normal statistical data gathering processes used for estimating gross domestic product and other important aggregates of economic activity. This terminology has been adopted by the Australian Bureau of Statistics (ABS) for many years and the ABS has also adopted the OECD’s framework for decomposing the non-observed economy into constituent components for further analysis:

1. **Underground production:** Activities that are productive and legal but are deliberately concealed from public authorities to avoid payment of taxes or compliance with regulations.
2. **Illegal production:** Productive activities that generate goods and services forbidden by law or that are unlawful when carried out by unauthorised procedures.
3. **Informal sector production:** Productive activities conducted by unincorporated enterprises in the household sector or other units that are unregistered and/or less than a specified size in terms of employment, and that have some market production.
4. **Production of households for own-final use:** Productive activities that result in goods or services consumed or capitalised by the households that produced them.
5. **Statistical underground:** Defined as all productive activities that should be accounted for in basic data collection programs but are missed due to deficiencies in the statistical system.

***To help the Committee better understand the tax non-compliance issues of interest, technically speaking all of the economic production in categories 1 to 3 constitute the so-called ‘cash economy’.***

Government statistical bodies internationally generally pursue a policy of exhaustiveness in relation to preparing the National Accounts and as a result undertake a variety of research efforts to estimate the size of some/all of the abovementioned production categories. For example, ***it is the ABS’s current practice to make an adjustment of 1.5 percent of GDP to account for underground production***<sup>11</sup>. However, no estimates are made for other production components. For 2015-16, I have calculated that the ABS’s adjustment would have been somewhere of the order of \$23-24 billion. Other advanced economies (e.g. Austria, Canada, Netherlands, Sweden and United Kingdom) make similar estimates for concealed production that tend to be higher than Australia’s due to the inclusion of other production components (e.g. illegal).

The ABS’s adjustment for underground production is based on fairly dated benchmarks drawing on ATO compliance program outcomes. I understand that the ATO’s current tax gap research program may lead to the derivation of new benchmark data that would enable the ABS to update its aggregate of underground production.

1) *Underground production*

As evident from the estimates of statistical bodies in Australia and some other advanced economies, ***underground production constitutes the main component of the cash economy***. However, the activities and types of behaviours that fall within its scope are extremely diverse in practice and ***the legislative frameworks in place to help deter and detect such activities and behaviours have, in my view, many gaps and shortcomings, pointing to the significant challenges that confront the ATO and other arms of government that are impacted***—see Table 4.

**Table 4. Issues concerning the effective administration of the cash economy**

Challenges confronting tax administration	
Behaviours	Facilitated by
Skimming of business proceeds, especially in the retail sector.	<p>There is no law barring retail businesses from transacting on a “cash only” basis- a practice sometimes observed in areas such as hospitality. (NB: This can be contrasted with, for example, the business practice of UBER that requires all payments by credit card—no cash!)</p> <p>There is no law barring businesses offering ‘discounts’ for payments in cash to discourage use of electronic payments or cheques that must be banked, most likely with intended tax evasion and other non-compliance in mind.</p> <p>There are no limits on the value of cash transactions between parties for goods and services (as seen in some countries).</p> <p>Despite enormous growth in the use of electronic payments for B2B and C2B transactions, there is no legislated reporting obligation on financial intermediaries (as there is in the USA) to report the incomes of businesses captured electronically</p>

<sup>11</sup> The ABS provides a comprehensive description of its methodological approach in this area in *‘Information Paper: The Non-Observed Economy and Australia’s GDP’*, 2012, 5204.0.55.008. For 2010-11, the adjustment made for underground production was equivalent to \$20,722 million.

	to the ATO, as there is for employee income, that would encourage proper reporting and facilitate verification of reported business incomes.
A failure to report for tax purposes some B2B payments for services rendered.	Lack of systematic reporting obligations to the ATO on B2B payments other than for the building and construction industry. (Ireland has some useful examples in this area.)
Services to households in cash only, particularly in the area of building and construction, and property maintenance.	No incentive or system for households to report such payments. (For example, Canada’s home renovation tax credit.)
“Cash-in-hand” wages paid to employees without the required tax withholding, reporting and employer payment of superannuation guarantee.	There are no legislated requirements on employers that mandates payments of employees’ wages to their bank accounts.
Undeclared rental incomes, especially where payments are made direct by the lessee to lessor.	There are no legislated information reporting requirements on lessees or managing agents collecting rents to report such income to the ATO.
Undeclared tips and gratuities, especially in the hospitality sector.	There are no legislated information reporting requirements on employers to report such income to the ATO.

Better tools of the kind described in Table 4 and their effective administration should contribute over time to a fair reduction in cash economy behaviours and improved compliance with tax and other regulations. Hopefully, these and other important issues will be considered by the recently-initiated taskforce that is examining these issues<sup>12</sup>.

### 2) *Illegal production*

While the Committee may not want to delve into this area, there are a few points worth noting:

- a) Illegal production also arises in many guises (e.g. illegal tobacco and fuel products, prostitution, and sale of drugs) and there are examples of government policy that create incentives for such production (e.g. high tobacco and petroleum excises).
- b) The ABS currently makes no adjustment to the National Accounts for illegal production, although there appears an intent to do so and some preliminary work has been carried out.
- c) In some advanced economies where official estimates have been made of illegal production, these estimates are relatively small and often do not cover all forms of illegal activity.

### 3) *Informal production*

This sector focuses on economic activities such as childcare in the home, private household services (e.g. cleaning), other personal care services, and direct sales to consumers of agricultural products (e.g. market stalls, road-side sales). The ABS has reported that no explicit adjustments are made for informal production as it is not believed to be material in the Australian context<sup>13</sup>.

### ***A longer term agenda..... but perhaps not that far away***

<sup>12</sup> A ‘Black Economy Taskforce’, Minister for Revenue and Financial Services’ Press Release (14 Dec. 2016)

<sup>13</sup> ‘Information Paper: The Non-Observed Economy and Australia’s GDP’, 2012, 5204.0.55.008

Finally, it is my view that Government could play an important role in this area through the promotion and adoption of policies that actively encourage and facilitate the eventual elimination of traditional forms of currency (i.e. notes and coins), with all payments made by electronic means only. There are indications that other countries are making much progress in this direction (see Annex 3).

### **6) Taxpayers' compliance costs are very large and justify a substantive response**

A factor critical to taxpayers' engagement with the tax system are the costs to them of doing so. In tax literature and particularly in the Australian context, these costs are referred to as 'tax compliance costs'. The study into Australia's future tax system made numerous observations on the complexity and compliance costs arising with Australia's tax system. For example;

*"Many people find the personal income tax system complex, not only because of the rates scale and the lack of a coherent definition of taxable income, but also because they must deal with a large set of complex deduction rules, numerous tax offsets and different forms of exempt income. A consequence of this is that the system is not transparent to taxpayers. It can be difficult for taxpayers to have a sense of their taxable income because of the complex rules associated with deductions, which are claimed by 80 per cent of personal income tax-filers. A common response to this and other forms of complexity in the tax system is to seek advice from a tax agent. Around three quarters of tax-filers seek such assistance. Nonetheless, in 2007–08, 86 per cent either claimed no deductions at all or only claimed work-related expenses, gifts and the costs of managing tax affairs. This suggests that the system is too complex and the compliance burden too high (AFTS, Volume 1, page 6)*

*"The complexity of the current system imposes considerable costs on the community. It has exposed both taxpayers and government to higher levels of risk and uncertainty. This has led to behaviours that add to the cycle of increasing complexity." (AFTS, Vol. 2, page 653).*

Various efforts to quantify the size and distribution of the tax compliance costs arising with Australia's federal tax system have been made over the years. The most recent assessment of their magnitude can be found in a report published by the Australian Treasury in 2015. The key points in Treasury's report relevant to this submission are as follows;

- ***The aggregate annual compliance cost of tax regulation has been estimated at approximately \$40 billion***—over 10 percent of net revenue collections;
- An estimated \$12 billion in compliance costs is estimated to be attributable to income tax; however, this amount while including corporate income tax excludes external fees estimated at \$14 billion (across all taxes) and \$1.1 billion for PAYG withholding tax. ***Given the overwhelming reliance on income tax, the total compliance cost burden of income tax could quite easily be in the region of \$20-25 billion per annum.***
- Viewed by taxpayer segment, Treasury's findings show compliance costs for individuals (\$7.3 billion), small businesses (\$18.6 billion), medium businesses (\$7.6 billion), and large businesses (\$2.5 billion).

Consistent with the Government's stated goals to reduce regulatory burden, the tax system would seem a prime candidate for attention.

## **Part B. Reform suggestions—how many taxpayers might engage in the future**

*How could taxpayers engage in the future?*

- How do other tax systems operate<sup>4</sup> and how do they compare to Australia?
- Do other service delivery organisations (including overseas tax authorities) provide any particular behavioural insights (fairness, social norms and group effects) that could be adapted to the tax system?

### **Considerable change is needed and early reform action is warranted**

Given the costs and challenges outlined in Part A and consistent with the findings of the AFTS study report, it is my view that a new approach is required for the majority of individual taxpayers, one which would greatly simplify their obligations and reduce their compliance burden. In so doing, it would also reduce the need for these taxpayers to engage tax agents, freeing tax practitioners to devote more attention to higher value work (e.g. assisting small businesses and late lodgers).

Fortunately, a number of the key elements of such approach have already been identified in the AFTS report, the relevant recommendations of which are summarised in Box 1. To assist the Committee, some brief background from the AFTS report follows.

#### **Box 1. AFTS report: Key recommendations to facilitate personal tax administration (with writer's underlining)**

- **Recommendation 123:** Pre-filled personal income tax returns should be provided to most personal taxpayers as a default method of settling their tax affairs each year.
- **Recommendation 11:** A standard deduction should be introduced to cover work-related expenses and the cost of managing tax affairs to simplify personal tax for most taxpayers. Taxpayers should be able to choose either to take a standard deduction or to claim actual expenses where they are above the claims threshold, with full substantiation.
- **Recommendation 12:** There should be a tighter nexus between the deductibility of the (WRE) expense and its role in producing income.

Source: AFTS Report 2010, Australian Treasury.

#### **1) *Legislative change to tighten the rules for WRE deductibility***

The AFTS study paid particular attention to work-related deductions and, in particular, pointed to the significant costs and other challenges presented by their pervasiveness. For example, the report of Australia's Future Tax System (2010) observed:

*"The law for WREs is complex (supported by numerous ATO decisions, determinations and rulings). While the general principles are simple, many tax rulings, court rulings and legislative provisions underpin their application. WREs impose a compliance burden on individuals and practitioners and add to administration costs for the ATO.*

*Under the current framework, there are significant difficulties in correctly quantifying work-related costs, in apportioning expenses between income-earning purposes and private purposes, and in defining and claiming the deductions. These complex arrangements constitute one of the*

*impediments to further pre-filling of tax returns and, ultimately, removing the need to complete a tax return for a large number of employees.” (Vol.1, Personal Tax, page 55)*

*“Under the current system an expense may be deductible as long as it is sufficiently related to earning income. The necessary link is considerably looser than in other countries. The current test adds to compliance costs, makes it hard to move to pre-filled (automated) tax returns, and expands the net of allowable expenses to such an extent that it is difficult to check that expenses conform with the law. Requiring a tighter link between an expense and gaining income would improve clarity for taxpayers on what they can deduct and would ensure that WREs and other deductions are well-targeted.” (Vol.1, Personal Tax, page 57)”*

The AFTS study report also observed that Australia’s regime for WRE was much more generous than observed in many other countries, noting:

*“Compared to Australia, a number of countries that allow deductions for WREs do so only for a very limited and carefully prescribed set of expenses (see Box A1–2). In addition, the nexus between deductible expenses and income generation is much tighter than it is in Australia.*

(Box A1-2 of the AFTS report is reproduced at Annex 2.)

As a consequence of its deliberations, the AFTS report recommended that the rules for deductibility be tightened. I strongly concur with this recommendation.

## **2) The introduction of a standard deduction in respect of specific non-itemised tax deductions**

Acknowledging the compliance burden imposed by the considerable degree of itemisation occurring with tax returns and other factors, the AFTS report also recommended the introduction of a standard deduction:

*“An automatic standard deduction should be introduced to simplify people's interactions with the tax system and facilitate much greater levels of pre-filling of tax returns. Work-related expenses are deductible from taxable income, on the grounds that it is fair to assess a person's disposable income taking account of costs they incur in earning that income. While they are the most commonly claimed deductions for employees, and claims have been growing substantially over recent years, they are also one of the key sources of complexity and compliance costs for individuals.*

*A standard deduction for the great majority of taxpayers would remove their need to collect receipts. A tighter nexus between the deductibility of the expense and its role in producing income would also constrain the scale of work-related deduction claims. To ensure that individuals with more complex affairs or high expenses are not disadvantaged, taxpayers would still have the option of substantiating a claim for all eligible expenses.*

*These two reforms, together with policy refinement to align income definitions and rationalise the number of personal tax deductions and offsets, would support the pre-filling of tax returns. Significantly, such changes would free most personal taxpayers from having to prepare their tax return, and instead allow them to lodge a default return prepared by the ATO. For most taxpayers, such default returns would only require them to provide minimal additional information or simply confirm the details in order to lodge their return. These reforms would allow personal taxpayers to avoid much of the complexity surrounding their tax return, as well as the expense of a tax agent.”*

In making the recommendation for a standard deduction, the AFTS report offered some practical guidance for its design:

- 1) For eligible taxpayers, the standard deduction would rise with income (i.e. being comprised of a nominal base amount and a proportion of labour income).
- 2) The deduction should be designed so as to free most taxpayers from having to prepare a tax return—these taxpayers would receive a summary of their tax affairs from the ATO which would be complete and accurate.
- 3) Taxpayers with unusually higher levels of WRE expenditure would continue to itemise their allowable deductions with substantiation; a threshold would be set for this purpose.

Looking to the future, I consider that a standard deduction should be designed so as to encompass the vast majority of taxpayers with relatively straightforward tax affairs. To this end, it could be calculated broadly in line with the prescription set out in the AFTS report and encompass deductions for WRE, along with deduction for gifts given their large volume and relatively low average \$ value/taxpayer—over 4.5 million claims with around two thirds less than \$250.

In my view, a standard deduction should exclude deductions for tax agents' fees, given the standard's overriding objective is to achieve simplification and negate the need for tax agent engagement. A relatively large threshold (e.g. \$3,000) should also be struck for accepting itemised WRE deduction claims with full substantiation required, reducing the claimant population to manageable numbers for ATO compliance checking purposes. As evident from the information in Annex 2, other countries make use of 'standard deductions'. It should not be beyond our competence to follow suit.

### ***Prefilled personal tax statements***

The AFTS study report envisioned a system where most taxpayers would receive a prefilled tax return .... "*as a default method of settling their tax affairs each year*". In short, the so-called return would be complete for most taxpayers. To avoid confusion with the current arrangements involving the prefilling of tax returns as part of the electronic filing process, this writer advocates use of the term 'personal tax statements' rather than 'prefilled tax return' as the overall process envisaged has some important differences.

Drawing on the practices of tax bodies that are considerably experienced with such arrangements (e.g. Denmark, Norway, and Sweden), the overall process could look as follows:

- 1) Taxpayers with simple affairs (as defined) would be eligible to receive a personal tax statement.
- 2) Prescribed third parties (e.g. employers and public companies) would have an obligation to report relevant information to the ATO shortly after the end of the fiscal year, enabling the ATO to generate personal tax statements for eligible taxpayers fairly soon thereafter.
- 3) Personal tax statements would set out details of a taxpayer's income, the quantum of their standard deduction, any tax offsets and credits, and net tax liabilities, including details of any refund potentially payable.

- 4) Taxpayers would receive their personal tax statement online (e.g. accessed via MyGov), accompanied with messaging of its availability. (NB: A paper version could be made available for designated situations that would be minimal in numbers.)
- 5) Taxpayers would be required to simply confirm (electronically) the accuracy of the information displayed. The expectation would be that the information would be fully accurate for the bulk of taxpayers; where this was not the case, taxpayers would be under an obligation to provide the further information required to determine their final tax liability. In both situations, the requirements on taxpayers would effectively amount to ‘self-assessment’.
- 6) Once taxpayers had confirmed the accuracy of their pre-filled personal tax statement, any refund due would be paid to them shortly thereafter, directly credited to their nominated bank account. Processes would be required to deal with taxpayers who did not respond.

In short, for most taxpayers the entire process would be effected relatively quickly online—straightforward and with negligible burden.

### **How the suggested reforms would impact today’s problems**

#### ***Over-claimed work-related deductions***

A combination of tightened rules for WRE deductibility and the introduction of a standard deduction would reduce the incidence of revenue leakage. Furthermore, with a much smaller population of taxpayers claiming WRE deductions, albeit for larger amounts on average, a much higher level of scrutiny could be achieved of this population of taxpayers.

#### ***Refund churn***

Taken in their entirety and subject to policy design choices, the proposals provide the opportunity to reduce the overall value of individuals’ tax refunds on assessment. This arises as a result of the following measures:

1. A standard deduction can be incorporated into PAYG withholding schedules, thereby leaving more money in the hands of employees during the year and helping to ensure that their overall annual withholdings more closely approximate their end-year tax liability; and
2. Deductions in the return assessment process would be reduced significantly for work-related expenses and tax agent fees.

#### ***Late lodgement of tax returns***

Under the proposals suggested, most taxpayers would receive a fully-completed personal tax statement in the first instance and would be only required to provide confirmation of its accuracy. Once this was done, any refund of overpaid taxes owing to the taxpayer could be paid. Operating in this way, the ATO would be the initiator of the annual tax assessment process for these taxpayers, thereby being in a position to bring most taxpayers to account, assisted with various incentives (e.g. processing of refunds).

With a far lesser number of taxpayers needing to engage tax agents, the tax profession would have increased capacity to service other taxpayers whose affairs are more complex and returns more detailed, and the population of citizens who historically have been late lodgers/ never lodgers.

### ***Taxpayers' compliance costs***

For the majority of taxpayers, there would be reductions in their compliance costs resulting from the following measures:

1. Less record-keeping associated with the minutiae of work-related deductions (over \$300) and gifts (over \$2).
2. Employees would pay less tax in advance, meaning that the cost they incur as a result of 'the time value of money' would be less than arises under current arrangements.
3. Reductions in time spent visiting and discussing tax affairs with tax agents, and savings from reduced use of tax agents and the fees they charge (after the benefit of any tax deduction).

### **Part 3. Implementation as part of a longer term policy agenda**

*How does this best inform a longer term policy agenda?*

- How would potential changes fit within the existing tax system? Are there any broader sensitivities, impediments or other changes that need to be in place first?
- Who would carry the compliance burdens and who would receive the compliance benefits? Are there ways of minimising these costs?

As set out in Part 1 of this submission, there are a range of factors pointing to the need for reform action sooner rather than later. Significant compliance costs are being incurred and the likely level of revenue leakage through over-claimed WRE is a concern.

It is also worth noting that since 2008 the ATO has made good progress towards establishing the technological environment (i.e. systems and processes) required that would enable it to prepare fully-completed personal tax statements for most taxpayers. There now appears to be reasonably efficient processes for capturing large volumes of data from relevant third parties (e.g. employers and financial institutions) and to the extent there are shortcomings in this area these are unlikely to be significant. The system for prefilling tax returns is well established and taxpayers are familiar with the process of relying on income and other data accumulated for them by the ATO to prefill their returns. Furthermore, user interfaces have recently been enhanced and citizens have become more connected, and used to, interacting with government electronically (i.e. MyGov). Finally, adequate security and authentication mechanisms appear to be in place, although with potential for easier to use interfaces.

### **Collecting income tax on employment income: Non-cumulative and cumulative forms of tax withholding**

The following hereunder has been extracted from the OECD's tax administration comparative information series<sup>14</sup>.

**Cumulative withholding regimes:** The objective of the cumulative approach to employee withholding is to ensure that for the majority of employees the total amount of taxes withheld over the course of a fiscal year matches their full-year tax liability. To the extent this is achieved, employees are freed of the obligation to prepare and file an annual tax return, the primary benefit frequently attributed to the cumulative approach. Under this approach, employees are required to provide employers with details of relevant entitlements to assist them determine the amount of tax to be deducted from their earnings. In some countries (e.g. Ireland and United Kingdom), employees provide this information to the revenue body which in turn advises the employer of a code that determines the amount of tax to be deducted from earnings. Employers withhold tax from income paid, as required, determining amounts to be withheld on a progressive/cumulative basis over the course of the fiscal year. Employees changing jobs during the course of a fiscal year must inform their new employer of their tax position and, in some countries, the revenue body as well.

Under the cumulative approach, employees tend to have few entitlements (that reduce tax payable) as this enables greater accuracy in calculating the amount of taxes withheld over the course of a fiscal year vis-à-vis their end-of year tax liabilities. However, in two countries (i.e. Japan and Korea), employee taxpayers can present details of certain deductions/entitlements to their employers towards the end of the fiscal year for an adjustment to their overall withholdings for the year.

Employers report annually or more regularly in some countries, to revenue bodies on incomes paid and taxes withheld in respect of individual employees. Increasingly, this reporting is being done using electronic reporting methods. For some countries, this reporting facilitates checks that are carried out to ensure that the correct amount of tax has been paid and/or to determine whether taxpayers are required to file a tax return. In practice, the operation of withholding regimes for other categories of income (e.g. for interest income) complement the employment cumulative withholding arrangements and together ensure that most employees are not required to file an end-year tax return.

**Non-cumulative withholding:** The alternate approach to withholding on employment income is described as "non-cumulative". By way of contrast, the non-cumulative withholding approach operates on a "pay period" basis for each employee. Under this approach, employers withhold taxes for each pay period having regard to their gross income, known entitlements (that may reduce the amount to be withheld) and the rate of withholding to be applied. Where an employee changes jobs, the new employer simply commences the withholding process on the employee's future income without regard to his/her previous employment withholdings. However, as this approach involves a less precise form of withholding, the amount deducted for each employee over the course of a fiscal year represents only an approximation of their full-year tax liability. In these circumstances, employees are normally required to file annual tax returns to ensure that the correct overall amount of tax is paid (and to obtain a refund of any overpaid tax), taking account of all categories of assessable income and entitlements (e.g. tax deductions and credits), as well as any other responsibilities administered by the revenue body that may be linked to the personal tax system (e.g. collection of student loans).

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<sup>14</sup> *Tax Administration 2015*, OECD Paris, page 297.

**Extract from the AFTS Report: International Comparison of Deductions for WRE**

**Box A1–2: International comparisons of deductions for WREs**

Country	Deductions for work-related expenses	Scope of deductions and arrangements
Australia	Yes	Incurred in gaining or producing an employee's assessable income.
Canada	Limited	Only deductions specifically legislated are allowed, including accounting and legal fees.
Denmark	Yes	Wage or salary earners can fully deduct work-related expenses from income, after a standard deduction has been applied.
Ireland	Yes — narrow	Expenses incurred wholly, exclusively and necessarily in the performance of duties.
Japan	Limited	Specific deductions that exceed the standard deduction for employment income are allowed. Specific deductions include travelling expenses.
Netherlands	Yes — narrow	Most work-related expenses are not deductible; in limited circumstances exceptions apply for transport, education and home office expenses. There is an employed person's tax credit.
New Zealand	No	No deductions for work-related expenses for employees.
Spain	No	Expenses relating to employment are generally not deductible. Some exceptions include trade union / professional association fees and legal expenses on termination. Other allowances and a standard deduction are available.
Switzerland	Yes — narrow	Necessary work-related expenses are deductible — 3 per cent of net income with a minimum and maximum deduction.
United Kingdom	Yes — narrow	Most claimable expenses must be incurred wholly, exclusively and necessarily in the performance of an employee's duties, a condition that precludes the deduction of many employment-related expenses.
United States	Limited	Employees can deduct work-related expenses subject to limits (expenses generally only deductible to the extent they exceed 2 per cent of adjusted gross income). Taxpayers have the option of claiming a standard deduction in lieu of itemising deductions.

Source: Adapted and updated from *International comparison of Australia's taxes* released April 2006, OECD *Taxing Wages 2007–08* and International Fiscal Database Documentation.

## Sweden: Moving to get eliminate cash

the **guardian**

# Sweden leads the race to become cashless society

Swedes are blazing a trail in Europe, with banks, buses, street vendors and even churches expecting plastic or virtual payment



The Swedish banknotes issued last year: circulation of the krona has fallen sharply as electronic payment takes over.  
Photograph: Fredrik Sandberg/EPA

**Jon Henley**

Sunday 5 June 2016 01.00 AEST

In 1661, Stockholms Banco, the precursor to the Swedish central bank, issued Europe's first banknotes, on thick watermarked paper bearing the bank's seal and eight handwritten signatures.

Last year - as Britain did last week - Sweden launched a new series of notes, cheery affairs featuring 20th-century Swedish cultural giants such as Astrid Lindgren, the creator of Pippi Longstocking, Greta Garbo and filmmaker Ingmar Bergman. But like its Nordic neighbours Norway, Denmark and Finland, Sweden is fast becoming an almost entirely cashless society.

"I don't use cash any more, for anything," said Louise Henriksson, 26, a teaching assistant. "You just don't need it. Shops don't want it; lots of banks don't even have it. Even for a candy bar or a paper, you use a card or phone."

Swedish buses have not taken cash for years, it is impossible to buy a ticket on the Stockholm metro with cash, retailers are legally entitled to refuse coins and notes, and street vendors - and even churches - increasingly prefer card or phone payments.

According to central bank the Riksbank, cash transactions made up barely 2% of the value of all payments made in Sweden last year - a figure some see dropping to 0.5% by 2020. In shops, cash is now used for barely 20% of transactions, half the number five years ago, and way below the global average of 75%.

And astonishingly, about 900 of Sweden's 1,600 bank branches no longer keep cash on hand or take cash deposits - and many, especially in rural areas, no longer have ATMs. Circulation of Swedish krona has fallen from around 106bn in 2009 to 80bn last year.

"I think, in practice, Sweden will pretty much be a cashless society within about five years," said Niklas Arvidsson, an associate professor specialising in payment systems innovation at Stockholm's Royal Institute of Technology (KTH).



A shopping mall in Stockholm. Cash is used for only about a fifth of all transactions in shops. Photograph: Frank Chmura/Alamy

Arvidsson argues that the country's head start in the field began in the 1960s, when banks persuaded employers and workers to use digital bank transfers for wages as a matter of course, with credit and debit cards receiving a boost in the 1990s when Sweden's banks started charging for cheques.

Cards are now the main form of payment: according to Visa, Swedes use them more than three times as often as the average European, making an average of 207 payments per card in 2015.

More recently, mobile phone apps have also taken off in spectacular fashion. Swish, a hugely popular app developed jointly with the major banks including Nordea, Handelsbanken, SEB, Danske Bank and Swedbank, uses phone numbers to allow anyone with a smartphone to transfer money from one bank account to another in real time.

"Swish has pretty much killed cash for most people, as far as person-to-person payments are concerned," said Arvidsson. "It has the same features as a cash payment - real-time clearing, the same as handing over a banknote. And it's now making inroads into payments to businesses, too."

Adopted by nearly half the Swedish population, Swish is now used to make more than 9 million payments a month. (A similar Danish app, MobilePay, was used by over 3 million Danes - in a country of 5.6 million - to make some 90 million transactions last year.)



Stockholm's Metro does not accept cash payments.  
Photograph: Alamy

Street salesmen, from hotdog vendors to homeless magazine sellers, have enthusiastically adopted iZettle, a cheap and easy Swedish system designed to allow sole traders and small businesses take card payments via an app and mini card-reader plugged into their phones, with many reporting sales increases of up to 30%.

Even Swedish churches have adapted, displaying their phone numbers at the end of each service and asking parishioners to use Swish to drop their contribution into the virtual Sunday collection. One Stockholm church said last year only 15% of its donations were in cash; the remainder were all by phone.

There are, obviously, concerns: cases of electronic fraud have more than doubled in the past decade and several critics - including the inventor of iZettle, Jacob de Greer - have asked whether an entirely electronic system in which every single payment is recorded is not a threat to privacy.

Old people's organisations also fear that those who prefer cash, out of a reluctance to use new technology or simply because they find it easier to keep track of their spending, will be disadvantaged, while educators worry that young people will be tempted to spend money they do not have.

For these and other social reasons, Arvidsson said, cash is not dead quite yet. "Even if, in the next few years, Swedes use almost no cash at all, going 100% cashless needs a political decision," he said. "The idea of cash, even in Sweden, remains very strong."