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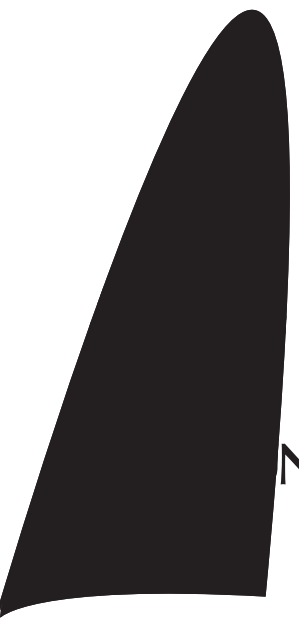
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Tax return simplification: risk key engagement, a return to risk?

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Abstract

Australia's personal income tax system is at the point of no return. The momentum for administrative simplification is such that the majority of taxpayers may soon be alleviated of the onerous task of lodging tax returns. This is despite the fact the Henry Review recommended the tentative option of default pre-filled tax returns, rather than the bolder move to a reduced filing system (like the UK and New Zealand – where most taxpayers do not have to do anything at the end of the year). But what will the impact of such a move be on taxpayer engagement, given that for most people this is their only interaction with the tax system during the year? Will Australia be risking taxpayer engagement with the system for the sake of simplification?

This article looks at the concept of a default pre-filled tax return within the Australian context. It contrasts this with the system of reduced filing used in the UK and New Zealand, and draws similarities with New Zealand's personal tax summary. Where relevant, it explores the literature on taxpayer engagement amid the concern that taxpayers may potentially engage less with the tax system if they do not have to lodge tax returns.

The article concludes by suggesting best practice in future tax administration may be a hybrid system where elements of both reduced filing and pre-filing co-exist. Put simply, people with simple tax affairs will not have to lodge tax returns and those with more complex arrangements will file pre-filled returns. The debate as to whether we should have tax returns or not for people with simple tax affairs may therefore be a moot point. The real question for the future would be, and one worthy of further research, whether revenue authorities should continue to issue refunds to the majority of taxpayers.

1. INTRODUCTION

There's a time for playing it safe and a time for risky business. Even though this may be a tagline from a 1983 Hollywood film, it is equally apt to modern tax administration. For while there has been much focus on simplifying personal income tax (PIT) returns over recent years, the Australian experience has been somewhat modest and incremental. Indeed, even within the climate of PIT reform, unshackled from the burden of having to play it safe, recent official proposals in PIT administration have not been as ambitious as what they could have been. As Cooper notes: '[w]hile the Review of Australia's Future Tax System proposed some measures which would reduce the compliance burden for individuals, it was insufficiently bold in its recommendations.'² Evans and Kerr suggest the best reform in tax return

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simplification may not be one that is slow and tentative, but one that is made in quantum leaps using large packages.³ But what is the relevance of what academics think when it comes to tax administration? As Sandford noted, 'academic research and government concern are intimately interconnected'.⁴ Possibly a healthy intimacy - academics can be risky with theory, but it is government who make the business decisions and administrators who in turn carry those decisions out.

Implementing tax measures in a complex and changing world means that the role of administrators can indeed be risky. There are many risks, including risks to revenue, reputation (confidence), compliance and engagement. Despite this, in an environment where ideas, innovations and information are shared on an increasing basis, modern tax administrations are becoming more adaptable to risk as they continue to move from being inward looking and procedure focused, to outward looking and taxpayer focused. In an age of technology, modern tax administrators can probably afford to be less cautious with those taxpayers who have simple tax affairs and tax withheld at source. Australia is fairly well placed in this regard as most taxpayers want to do the right thing.⁵ Being less cautious means making it easy and simple for taxpayers to interact with the tax system. For most Australians, this interaction (involving high

needed for means testing.⁸ While it would seem that Van der Heeden's first and third points are one in the same, these arguments generally do form the basis for most opposition to a reduced filing system.

Calls for reduced filing in Australia have come from a range of quarters.⁹ The idea was also canvassed by the Australia's Future Tax System Review Panel (Henry Review),¹⁰ as 'abolishing returns', though the final report fell short of outlining any such bold recommendation, opting more for a status quo approach - 'pre-filled personal income tax returns should be provided to most personal taxpayers as a default method of settling their tax affairs each year'.¹¹ Despite this, reduced filing was again raised at the Australian Government's Tax Forum in 2011 with the simplification of tax returns seeming to dominate the first half of discussion in the 'Tax System Governance' session. As Evans and Kerr noted, those arguing in favour of the alternate pre-filing approach to tax return simplification probably held greater sway at the forum.¹²

This paper attempts to pick up the thread from the Tax Forum and explore the logical next steps for discussion. As such, the paper is divided into four main parts. Firstly there is a brief overview of the default pre-filled tax return to provide some context and description. New Zealand's personal income tax statement (PTS) is then outlined in part two, along with the impact that recent lodgment patterns are having on their reduced filing system. The literature on taxpayer engagement is then explored in the third section in order to provide insights as to potential impacts of simplifying the tax return process. All this relies on the mechanism of withholding tax, which is examined in the fourth and final part prior to a concluding note which highlights the remaining questions for further discussion and research.

2. DEFAULT PRE-FILLED TAX RETURN

The recommendation to implement a default tax return in Australia was the second of ten recommendations in the 'client experience' section (section G4) of the Henry Review.¹³ Using 2007-08 data, the Henry Review estimated about 11 per cent of the more than 12 million taxpayers who lodge tax returns would benefit from a default pre-filled tax return.¹⁴ Interestingly, and possibly not just coincidentally, approximately 11% of personal taxpayers lodge tax returns within the first month of the lodgment period (July 1 to July 31). As the Australian Taxation Office (ATO) notes:

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

⁹ See eg. Chris Evans, 'Diminishing Returns: The Case for Reduced Annual Filing for Personal Income Taxpayers in Australia' (2004) 33 *Australian Tax Review* 68; Chris Evans and Paul Drum, 'Ten Million Reasons for Personal Tax Reform in Australia' in Margaret McKerchar and Michael Walpole (eds) *Further Challenges in Tax Administration* (2006) 377.

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

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

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

¹³ Australia's Future Tax System Review Panel, 13

[B]ecause it will be late July or mid-August before much of the information we receive from third parties is available for pre-filing purposes, the full benefits of pre-filing may not be available to the 1.5 million or so taxpayers who lodge their returns in July.¹⁵

It would be fair to say that generally these would be people with simple tax affairs. For these taxpayers it would be arguable whether a pre-filled return would be of any major benefit as their tax affairs may be so straight-forward that the time taken to enter their income details could be less than the time taken to pre-fill a return. In 2009-10, 2.5 million personal taxpayers lodged their income tax returns using e-tax (the ATO's free self pre-preparer application), of whom 72% chose to use the pre-filing service.¹⁶ This compares to 2.37 million using e-tax in 2008-09 and 1.74 million (73%) who pre-filled.¹⁷

The rationale behind the recommendation for default pre-filled tax returns is founded in analysis of human behavioural research suggesting assisted decision-making and choice 'nudging' in order to help taxpayers make complex decisions and alleviate the burden of complexity.¹⁸ Nudge theory is often advocated by proponents of libertarian paternalism.¹⁹ This school of thought tends to argue for 'self conscious efforts by private and public institutions, to steer people's choices in directions that will improve the chooser's own welfare.'²⁰ Sunstein and Thaler suggest, because a default must be chosen, and because many individuals are likely to remain irrationally with the default option, it is better to set the default to the welfare-enhancing choice. While individuals remain free to deviate from the default option, they argue that those who advocate freedom of choice should not be troubled by this weak form of paternalism.²¹

Libertarian paternalism was behind the Cabinet Office in the United Kingdom (UK) establishing a 'Behavioural Insights Team' in 2010 to 'find intelligent ways to encourage, support and enable people to

It would seem these income statements would have been intended to provide the same function as default pre-filled tax returns. So even prior to the implementation of the pre-filing service in Australia (which went from a trial to full production in 2008),³¹ it would seem the necessary mechanisms and technology were already in place to produce such statements. This would certainly seem to be in line with New Zealand who introduced a PTS as part of their reduced filing system in the late 1990s.

3. NEW ZEALAND'S PTS

The reduced filing system in New Zealand was officially proposed in 1997 with the Government discussion document – *Simplifying taxpayer requirements*. The Government suggested the measures would ‘significantly reduce the compliance burden on taxpayers’,³² removing ‘many of the onerous, repetitive requirements that the current tax system places on salary and wage earners and employers’³³ and reducing ‘the extent to which the tax system intrudes on the lives of most individual taxpayers’.³⁴ Under this system, most taxpayers are relieved of the need to lodge tax returns, while some merely need to be issued with, or request, a PTS – which summarises a salary and wage earner’s income and tax deductions for the year. Inland Revenue automatically send a PTS to selected taxpayers based on their circumstances – criteria which has been extended in recent years to now include those who:

- x received Working for Families Tax Credits from Inland Revenue
- x received Working for Families Tax Credits from Work and Income and earned over:
 - \$36,827 for the 2010 tax year
 - \$35,914 for the 2009 tax year
 - \$35,000 for the 2007 and 2008 tax years
 - \$20,356 for the 2005 and 2006 tax years
 - \$20,000 for the 2004 and previous tax years
- x have a student loan and have not had enough money deducted from their salary, wage or benefit income. Inland Revenue will also send them an end of year repayment calculation for their student loan.
- x used the wrong tax code
- x used a special tax code
- x used a casual agricultural employee or an election day worker tax code and earned more than \$200 from that source
- x received income as an IR56³⁵ taxpayer only.³⁶

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

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

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

³³ Ibid.

³⁴ Ibid 1.

³⁵ An IR56 taxpayer can be a part-time private domestic worker, embassy staff member, New Zealand based representative of an overseas company or United States Antarctic program worker. They are required to pay their own PAYE tax to Inland Revenue.

³⁶ New Zealand Inland Revenue, *Individual Income Tax* (2010) New Zealand Inland Revenue <<http://www.ird.govt.nz/income-tax-individual/end-year/pts/>> at 18 March 2012.

Table 1: PTS requests³⁷

You must request a PTS if you...	and you received more than \$200 of ...
received income from \$48,001 to \$70,000	interest taxed at less than 33%.
received income over \$70,000	interest or dividends taxed at less than 38%.
received income over \$48,000	taxable MARI authority distributions.

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

	Mar 01	Mar 02	Mar 03	Mar 04	Mar 05	Mar 06	Mar 07	Mar 08	Mar 09	Mar 10
IR3 ⁴¹ s lodged	966.9	972.6	974.3	981.0	982.0	1,059.2	1,083.7	1,114.3	1,186.5	1,221.6

Another recent proposal of note has been the bid to make New Zealand's PAYE (pay-as-you earn) a final tax. The concept of PAYE as a final tax would apply only to taxpayers in stable employment for 11 months or more in the income year. Those who earned wages and salary income for 10 months or less in the year would still continue to be able to square-up their PAYE at year's end.⁴⁶

The New Zealanders therefore seem to be tightening their withholding system even further, re-iterating their commitment to a system where most people will not lodge tax returns.

Interestingly, in the UK, HMRC are looking at the potential of using pre-filled tax returns (for taxpayers with complex affairs) and online individual client accounts. As David Gauke, Exchequer Secretary explains:

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a tax return could also be seen as a civic duty that increases 'tax consciousness'. Tax consciousness is the awareness of taxpayers of their tax contribution, and, more generally, an interest in how it is being spent. The taxpayer's duty to lodge a return is one of the responsibilities of citizenship and arguably a requirement that leads to greater awareness of the cost of government and transparency of tax burdens.⁵² Zelenak suggests that as paying tax is an important civic duty, it requires a ceremony 'and the filing of one's tax return is that ceremony.'⁵³ Despite this, Zelenak concedes that an individually based reduced filing system, such as PAYE in the UK can confer some sense of widespread taxpayer status, but not to the extent of a return-based one.

While the impact that filing tax returns has on taxpayer engagement has not been studied specifically, active participation more generally has been shown to have a positive effect on taxpayer engagement. Pommerehne and Weck-Hanneman conducted empirical analysis among the Swiss cantons on the influence of direct participation on tax compliance.⁵⁴ Switzerland was chosen as various cantons have differing degrees of public participation in the political, budgetary and regulatory process. The results showed that among other factors, the extent of direct participation had a positive and significant impact on tax compliance. Pommerehne and Weck-Hanneman noted that for cantons with a high degree of direct political control, the average amount of concealed income (per capita of taxpayer) was, all things being equal, about 30 per cent less than the mean of all cantons.⁵⁵

Considering the act of tax return lodgment as akin to the wider scheme of active democratic participation may be drawing a long bow, however the similarity between voting and tax return filing is probably made even more pertinent in a country like

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tax returns) were in favour of taxpayers, 31 per cent of neutral favour and 12 per cent believed mistakes were generally to the disadvantage of taxpayers. They suggested this was reflected in the way taxpayers were treated and the relative respect given to taxpayers. Feld and Frey found that the more respectfully a tax authority treated taxpayers, the higher the level of voluntary compliance. In addition, they showed that tax evasion was lowest in the instances, where minor mistakes in the tax return were not treated as a misdemeanor, in contrast to intentional tax fraud being punished severely. While the results of this study are relevant, it should be noted that the survey of tax authorities took place at a time much later than the taxpayer data being studied. It does not seem the researchers accounted for any potential time discrepancies between the datasets.

The level to which taxpayers are engaged with the tax system may extend beyond the mere mechanics of return filing towards something more fundamental and intrinsic. Feld & Frey go beyond the standard arguments and suggest the relationship between taxpayers and administrators can be modelled as an implicit 'psychological tax contract'.⁵⁷ They advocate that 'genuinely' rewarding taxpayers in an exchange relationship will increase tax compliance and should be considered as the dominant compliance strategy with administrators able to resort to punishment if such a measure fails. Frey observed that it is now generally accepted among behavioural economists that external intervention does not always crowd out intrinsic motivation; there are conditions under which it fosters 'crowding-in'.⁵⁸

Despite this, in reality, such notions possibly have very little relevance to the majority of personal taxpayers. This is because their tax compliance is 'quasi- voluntary' or 'voluntary by default' as virtually all their required income tax is withheld from their pay packets. Therefore the notion that active participation through the tax return increases tax engagement may be unfounded, as for the most part, taxpayers may give little thought to such matters. As Pope noted:

One of the weaknesses of the tax compliance field overall is that a high proportion of work is focused on individuals who are generally subject to withholding tax (PAYE/PAYG) on most, if not all, of their income, with much less on the self-employed, who have much greater discretionary power as to how much tax they decide to pay.⁵⁹

5. WITHHOLDING

Tighter withholding at source is about 'getting it right first time' and thereby eliminating the need for a year-end 'square-up' to reconcile tax paid against income earned. Shaw, Slemrod and Whiting note that withholding from income tax is widespread among developed countries and is required for wages and salaries in all

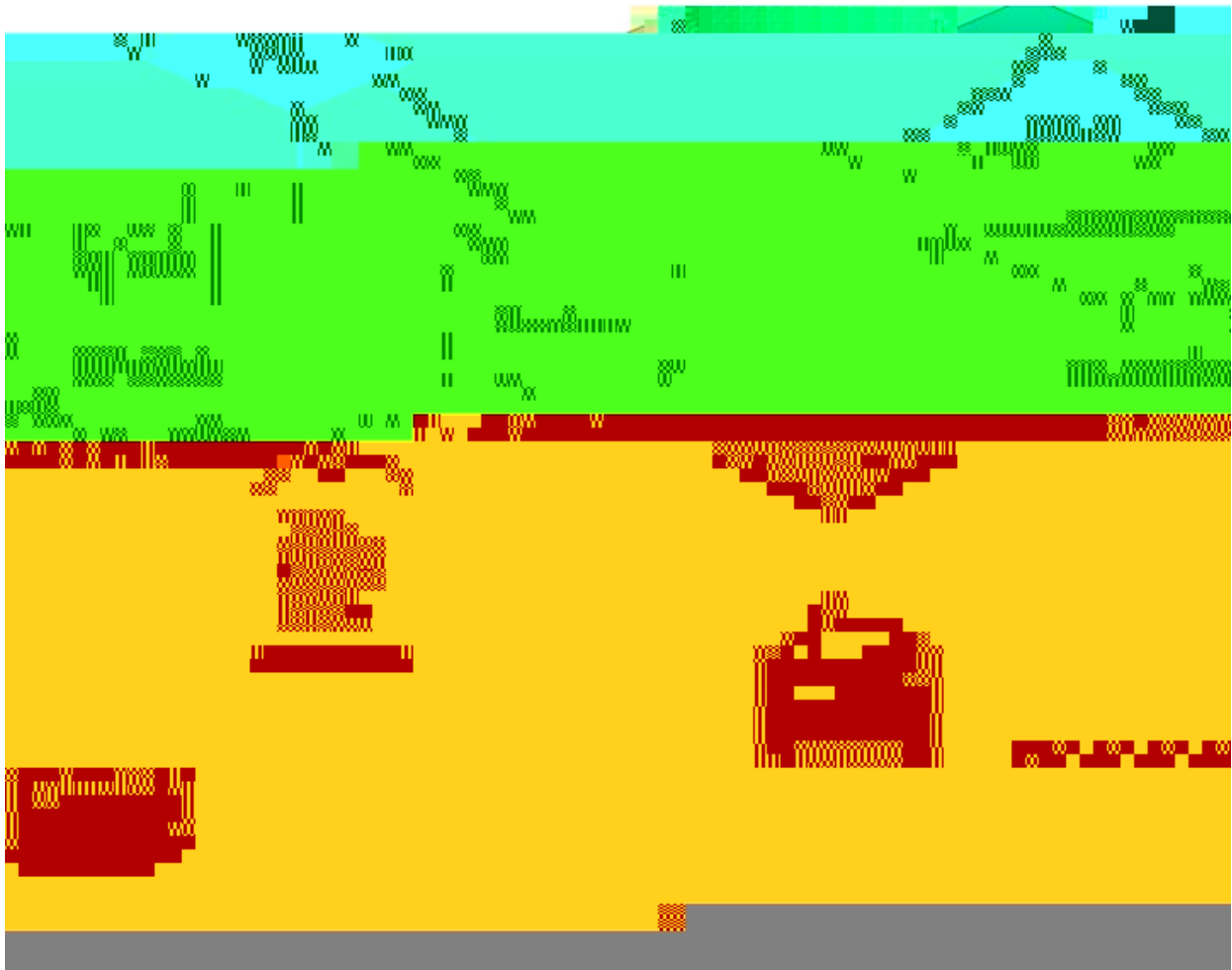
⁵⁷ Lars Feld and Bruno Frey, 'Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation' (2007) 29 *Law & Policy* 102.

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

⁵⁹ Jeff Pope, 'Benno Torgler, Tax Compliance and Tax Morale' (2008) 15 *Agenda* 73.

payments during the year, supported by robust withholding schedules and the ability to claim deductions. Indeed, though not necessarily economically rational, it is the annual expectation of refunded overpaid tax that may seem to be more critical. If the New Zealand experience has taught us anything, it is the realisation that the promise of a refund would seem to be one way of keeping people engaged in the system. Therefore a possible model for Australia, could a hybrid of both the reduced filing and pre-filing systems (as is being canvassed in the UK) where the majority of people do not lodge returns, and those with more complex tax affairs may have access to pre-filled information via an online account (similar to the ATO's current tax agent portal). Such a scenario is depicted in Figure 1.

Figure 1: Possible future PIT lodgment system



While there have been some laudable advancements in Australia towards such a system in Figure 1 (such as a portal for tax agents which includes clients' pre-filling data), there are still a number of issues to be addressed. Indeed, a range of factors have been identified as inhibiting the success of pre-filling in Australia. Highfield notes that the early availability of pre-filled return information has been a key part of the effectiveness of pre-filled returns in the Nordic region.⁶⁵ This can be contrasted with Australia however, where under legislation third party reporters are not required to supply the ATO with information until six weeks (for employment income) or four months (investment income) after the end of the income year. In most cases PAYG annual reports are required by no later than August 14 (Tax Assessment Act 16-153(2)) while the Annual Investment Income Report is required from investment bodies by October 31 following a financial year ending 30 June (sub-regulation 56(3) of the Income Tax Regulations). The ATO therefore relies on third party reporters to voluntarily provide the data required by the ATO earlier than the legislated requirements in order to enable the pre-filling activities to occur. The Australian National Audit Office suggested that given the Government's intention to simplify income tax returns by providing pre-filling services for around nine million individual taxpayers, the reliance on the goodwill of data providers to provide data earlier might not be sufficient to optimise the implementation and efficiency of the pre-filling initiative.⁶⁶ ATO statistics show that while approximately 75% of all total PAYG and welfare payment pre-filling data has been received by July 31, only about half of interest data and less than a quarter of dividend data has been received by the same time.⁶⁷

Evans and Tran-Nam summarise pre-filling's 'teething problems' as relating to: timeliness, comprehensiveness, availability, and reliability and accuracy.⁶⁸ These problems may possibly be due to the fact that 'the pre-filling initiative is partial and still at a very early and experimental stage in Australia'.⁶⁹ Notably, while the initiative is seen as a welcome simplification measure, in its current form it is 'unlikely either to have a significant impact on the compliance or administrative costs burden or to represent a significant step in the direction of a return-free tax jurisdiction for many or even some personal taxpayers'.⁷⁰

In order for the pre-filling service to be more successful and to ensure the effective implementation of a default pre-filled tax return, legislative amendments are an absolute necessity in order to remove current impediments.⁷¹ These amendments are best outlined in table form. Table 3 displays some of these changes, and while not

⁶⁵ Richard Highfield, 'Pre-populated Income Tax Returns: The "Next Big Thing" in Reform of the Administration of Australia's Personal Income Tax System' in Margaret McKerchar and Michael Walpole (eds)

exhaustive, such amendments would certainly provide a more comprehensive pre-filled tax return for the bulk of Australian personal taxpayers.

Table 3 – Simplification measures required to enable pre-filled default returns

Change required	What is the irritant?	Amendment/new provision
Reduction/elimination of deductions.	There are currently a total of 15 separate deduction questions in the individual tax return (ITR) for a myriad of various expenses, the vast majority of which need to be self-assessed by the tax payer. This layer of complexity provides pre-filing with a major impediment to the 'tick and flick' concept. In most instances, deductions create refunds. This would be the case even, and arguably more-so, with a \$1000 standard deduction. Refunds tend to encourage taxpayers to lodge earlier in the tax season, which also proves problematic to a full pre-filing experience.	Remove ITAA 1997 sec 8-1(1)a. Only those deductions which are expressly authorised by the Act may be made in calculating a person's tax liability. If a taxpayer wishes to claim a particular deduction they must be able to point to a provision which allows it.
More accurate withholding at source regime.	Pay-as-you-go withholding provides a broad approximation of tax liability often leading to an 'over-withholding' encouraging the earlier lodgment of tax returns. With a future move to reconciliation, there is a greater need to accurately withhold throughout the year. While Australia has withholding at source on interest and dividend payments, this does not extend to residents.	Possible introduction of individual 'tax codes' reflecting appropriate tax rate. Implementation of resident withholding regime (RWT). This would increase the effectiveness of pre-filing but also reduce the need for tax returns altogether for those taxpayers whose income has been accurately taxed at source.
Comprehensive third party reporting.	Investment bodies have 4 months after the end of year until they have to report. This can cause delays in the availability of the information for pre-filing.	RWT could incorporate mandatory reporting requirements bringing forward the date at which investment data is made available.

Change required	What is the irritant?	Amendment/new provision
Remove zone/overseas forces offset.	Self assessment aspect - residency does not have to be continuous. Zones do not always correlate directly to postcodes.	Potentially this negative taxation could be moved to the Social Security Act 1991.
Remove parent, spouse's parent, invalid relative offsets.	Relies on taxpayer self assessment of taxpayer household circumstances.	Removal of ITAA 1936 s159J.
Remove spouse, child-housekeeper or housekeeper.	Relies on taxpayer self assessment of taxpayer household circumstances - plus taxpayer calculation of spouse's SNI (which can not be pre-filled).	Could be argued that spouse offset is no longer relevant (The Government announced from July 1 2011 - a phase-out for spouses aged less than 40). ITAA 1936 s159J; 159H maybe better suited to Social Security Act 1991.
Alter the process for gift deductibility.	Current system prohibitive for pre-filling ad hoc gifts.	ITAA 1997 Div 30 could be amended to allow a gross up of the basic rate of income tax. A gift aid declaration could be implemented (similar to the UK).
Alter process for assessment of Medicare levy.	Irritants relate to the 6 exemption categories and the need to assess the eligibility of dependents in addition to the prescribed person eg. ½ Medicare levy exemption. Taxpayers also need to self assess where there is partial relief. Problems may also be encountered with eligibility to the reduction.	Due to the fact the tax system is being used to collect the Medicare levy - the tax unit could effectively

Change required	What is the irritant?	Amendment/new provision
Alter Senior Australians Tax Offset reporting requirements.	Difficult to pre-fill totally as spouse income required.	Coherent principles drafting may utilise consistency of tax unit throughout the legislation, including ITAA 1936 s 160AAA(1). Whether a taxpayer has a spouse could still be a

even exist.⁷³ In Denmark, taxpayers are not obligated to respond to a pre-filled return – a ‘no response’ is deemed to be acceptance of the return. The development of a default pre-filled tax return may therefore be self defeating in that its success will be its own obsolescence.

6. CONCLUSION

The impact of tax return simplification is yet to be fully explored. The answer is important. The prospect of disengaged taxpayers may worry some tax administrators. Likewise, the thought of continuing taxpayer engagement could be comforting to some, sleeping easy at night, resting safe in the knowledge that taxpayers remain fully connected with the system. Taxpayers may in fact wish to know every single scraps. s5w 0 Csngat.0