

# eJournal of Tax Research

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# **eJournal of Tax Research**

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# **eJournal of Tax Research**

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# Comparing the Swiss and United Kingdom cooperation agreements with their respective agreements under the Foreign Account Tax Compliance Act

Adrian Sawyer\*

## **Abstract**

An agreement between the United Kingdom (UK) and Switzerland came into force in early 2013,<sup>1</sup> providing for a process of clearing tax liabilities on UK residents' bank accounts in Switzerland, a withholding tax for future income and gains on such accounts, plus an authorisation for providing details to HM Revenue and Customs (HMRC). This paper compares this European-focussed initiative with the controversial enactment of the Foreign Account Tax Compliance Act (FATCA) in 2010 by the United States (US) Congress.<sup>2</sup> With regard to FATCA, the focus will be the decisions made by Switzerland and the UK to enter into intergovernmental agreements (IGAs) with the US and the resulting IGAs.

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\* Professor of Taxation, Department of Accounting and Information Systems, College of Business and Economics, University of Canterbury, Christchurch New Zealand.  
Email: [adrian.sawyer@canterbury.ac.nz](mailto:adrian.sawyer@canterbury.ac.nz).

An earlier version of this paper was presented at the Society of Legal Scholars Conference in Edinburgh on 5 September 2013. I would like to thank Colin Fong from the University of New South Wales for assisting me in obtaining copies of a number of the articles reviewed in this paper. This paper states the position as at June 2014 with respect to developments with the UK/Switzerland Agreement and with respect to FATCA.

<sup>1</sup> *Agreement between the Swiss Confederation and the United Kingdom of Great Britain and Northern Ireland on Cooperation in the area of Taxation* (London, 6 October 2011) and the Protocol amending the *Agreement between the Swiss Confederation and the United Kingdom of Great Britain and Northern Ireland on Cooperation in the area of Taxation* (20 March 2012).

<sup>2</sup> Pub. L. No. 111–147, 124 Stat 71 (March 18, 2010).

## 1. INTRODUCTION

Following the Global Financial Crisis (GFC), the pressure from governments to collect outstanding taxes, especially those from residents' offshore bank accounts, has risen dramatically. Initiatives include further efforts by the Organisation for Economic Cooperation and Development (OECD) to encourage expansion of the Global Forum on Tax Administration (Global Forum) while concurrently expanding the network of Tax Information Exchange Agreements (TIEAs) and bilateral double tax agreements (DTAs). A notable feature of this new emerging environment of enhance regulation is a series of globally reaching initiatives designed to facilitate the efforts of revenue authorities to collect outstanding taxes.

This paper seeks to examine the impact of two such initiatives. The first is the recent Switzerland–United Kingdom Tax Cooperation Agreement (Cooperation Agreement),<sup>3</sup> an example of the closer working relationship between the UK and Swiss Governments. The second is the 'controversial' enactment of the Foreign Account Tax Compliance Act (FATCA) as part of the Hiring Incentives to Restore Employment Act (the HIRE Act) in 2010 by the United States Congress.<sup>4</sup> In particular, it focuses on the Intergovernmental Agreements component of FATCA as between the UK and Switzerland.

The paper utilises document analysis and a review of the emerging literature to assess the potential impact of these two important developments in international taxation. It is policy focussed and takes a critical realist perspective with respect to both the 'global' initiatives reviewed and the decisions by the UK, US and Switzerland to be signatories to them. In a sense, this creates a novel triangular relationship between these three nations. What these initiatives may eventually give rise to forms the motivation for the paper. The UK was the first country to sign an IGA with the US, while Switzerland was the sixth. The Cooperation Agreement represents one of three similar agreements between the Swiss, and Germany and Austria, with the potential for a similar agreement with France to emerge in the future.

The signing of the Cooperation Agreement occurred on 6 October 2011, with the Cooperation Agreement coming into force on 1 January 2013.<sup>5</sup> This agreement is of significance, not only because Switzerland and the UK collectively managing approximately 50 per cent of the world's offshore wealth,<sup>6</sup> but it also marked a start of a gradual 'thaw' in Swiss bank secrecy.<sup>7</sup> The agreement provides for UK taxpayers that have assets held in Switzerland. In relation to UK domiciled taxpayers, they will

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<sup>3</sup> *Agreement between the Swiss Confederation and the United Kingdom of Great Britain and Northern Ireland on Cooperation in the area of Taxation* (London, 6 October 2011). This agreement has been amended by way of Protocol in 2012. The reference to the UK includes England, Scotland, Wales and Northern Ireland.

<sup>4</sup> Pub. L. No. 111–147, 124 Stat 71 (March 18, 2010). FATCA comprises sections 1471 to 1474 of the Internal Revenue Code 1986.

<sup>5</sup> *Agreement between the Swiss Confederation and the United Kingdom of Great Britain and Northern Ireland on Cooperation in the area of Taxation* (London, 6 October 2011) and the Protocol amending the *Agreement between the Swiss Confederation and the United Kingdom of Great Britain and Northern Ireland on Cooperation in the area of Taxation* (20 March 2012).

<sup>6</sup> See Itai Grinberg, "Emerging Countries and the Taxation of Offshore Wealth" (2013) *Georgetown Public Law and Legal Theory Research Paper* No 13–031, at 3 and 20.

<sup>7</sup> For an overview of Swiss banking secrecy and major developments, see Helga Turku, "The International System of States' Checks and Balances on State Sovereignty: The Case of Switzerland" (2012–2013) 38 *North Carolina Journal of International Law and Commercial Regulation* 809–874.

be subject to one of two outcomes. The first is a one-off payment on 31 May 2013 to clear past unpaid tax liabilities and/or a withholding tax on income and gains for the future from 1 January 2013. The alternative is that they will need to authorise their bank or paying agent to provide details of their Swiss assets to HM Revenue & Customs (HMRC). The one-off payment will clear those tax liabilities relating only to assets included in the figure of capital used in the payment calculation. In most cases, this will be the account balance at either 31 December 2010 or 31 December 2012. There are separate rules for non-UK domiciled individuals.

A potentially more dramatic development which is beyond the scope of this paper is Switzerland's decision in October 2013<sup>8</sup> to sign the OECD's revitalised Multilateral Convention for Mutual Administrative Assistance in Tax Matters (Multilateral Convention).<sup>9</sup> The Multilateral Convention, which acts as a form of support structure underpinning numerous bilateral DTAs and tax information exchange agreements (TIEAs), became 'globally' relevant with an amending protocol in 2010, which brought it into line with current international standards on transparency and exchange of information. As at 30 June 2014, 66 signatories/jurisdictions have signalled their commitment to the Multilateral Convention (including all of the G20 countries<sup>10</sup> and China), with 37 signatories to date having ratified the Multilateral Convention.

FATCA, as one of a series of provisions in the HIRE Act, is a US initiative to combat tax evasion by US persons holding assets in offshore bank accounts and through other offshore intermediaries. FATCA also represents the difficult political environment caused by the deferred prosecution by the US of UBS based in Switzerland. These provisions (together with a third provision that requires additional reporting by US investors in foreign investment companies) were designed to close down loopholes and increase tax compliance generally, by requiring investors to report and pay taxes on their income from US sources. However, projections suggest these provisions will raise revenue to offset the cost of tax incentives contained in the HIRE Act to encourage job creation. FATCA represents an evolutionary step in the international tax system according to Grinberg.<sup>11</sup>

In brief, FATCA obligates foreign financial institutions (generally offshore banks, private equity and hedge funds and other foreign financial institutions, known as FFIs) to enter into agreements with the Internal Revenue Service (IRS), disclosing the identities of US persons who hold accounts or interests in such FFIs. The failure by an FFI to comply with these rules will result in a 30 per

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<sup>8</sup> OECD, Switzerland signs Multilateral Convention on Mutual Administrative Assistance in Tax Matters (OECD, Paris, October 2013). At the time of writing Switzerland has yet to enact ratifying legislation.

<sup>9</sup> OECD, *Multilateral Convention for Mutual Administrative Assistance in Tax Matters* (1988), as amended in 2011 (CETS 127). See also the Council of Europe's (CoE's) *Explanatory Report on the Multilateral Convention* (2011).

<sup>10</sup> The G20 members are: Argentina, Australia, Brazil, Canada, China, France, Germany, Indonesia, India, Italy, Japan, Korea (Republic of), Mexico, Russia, Saudi Arabia, South Africa, Turkey, United Kingdom, United States, and the European Union. Details of signatories as at 3 July 2014 are available at: <http://www.oecd.org/tax/exchange-of-tax-information/a-boost-to-transparency-and-international-tax-cooperation.htm> (accessed 8 July 2014).

<sup>11</sup> Itai Grinberg, "Beyond FATCA: An Evolutionary Moment for the International Tax System" (2012) *Georgetown University Working Paper* (January 27, 2012). For an updated version of this working paper, see Itai Grinberg, "The Battle over Taxing Offshore Account" (2012) 60 *UCLA Law Review* 304–383. See also Scott D Michel, "FATCA: A New Era of Financial Transparency" (2013) 215(1) *Journal of Accountancy* 52–56.

cent withholding tax on all (or a portion) of payments made to the FFI. This includes US-source dividends, interest, and capital gains from the sale of US shares and securities (and certain other payments that are not generally relevant to private equity or venture capital funds) by the FFI. One of the myths about FATCA is that it is a tax; FATCA is not a tax but a mechanism to make it easier for the IRS to audit income and assets that would remain hidden offshore.<sup>12</sup> Thus essentially FATCA is designed not so much to collect tax but rather to compel FFIs and other entities to disclose on an annual basis information about US account holders who may not be complying with US tax reporting rules. FATCA was to apply to payments made to FFIs from 1 January 2014 with a phased application over the following three years. The application date was pushed back six months to 1 July 2014.<sup>13</sup>

The remainder of this article is structured as follows. In the next section, the article provides a brief review of recent efforts at enhanced tax cooperation between governments, followed in section 3 by an analysis of the key developments associated with the Cooperation Agreement between the UK and Switzerland. Section 4 focusses on the role of FATCA leading to the IGAs signed with each of the UK and Switzerland. Section 5 draws out a number of themes and issues from the preceding discussion, with section 6 setting out the concluding observations and suggestions for future research.

## 2. AN OVERVIEW OF THE TAX COOPERATION LITERATURE

Contributions on the subject of greater cooperation in taxation across borders are extensive, whether it is at the governmental level or by revenue authorities. It is not the aim of this paper to traverse this literature other than to highlight several recent contributions. The following discussion draws from an earlier paper by Sawyer.<sup>14</sup>

In the context of tax competition (the antithesis of tax cooperation), Genschel and Schwarz<sup>15</sup> provide an excellent overview of how the rise in tax competition of the 1980s and 1990s has gradually been displaced in much of the developed world by efforts to enhance tax cooperation, by both unilateral, bilateral and multilateral methods. The authors summarise the efforts at reducing tax completion through cooperation, highlighting that while there has been progress towards greater cooperation, this has not extended to greater tax harmonisation between nations.<sup>16</sup> In terms of future predictions, the authors see a slowdown in capital and corporate tax completion due mainly to domestic constraints following the GFC. They unsurprisingly predict a substantial rise in international tax cooperation, which is

<sup>12</sup> Kimberley Tan Majure and Matthew R Sontag, "FATCA: Myths, Mysteries and Practical Perspectives" (2012) 64(4) *The Tax Executive* 315–321, at 315. Majure and Sontag also emphasise that FATCA applies to non-financial companies, that payment of the 30 per cent withholding tax will not necessarily be a solution, along with a number of other key practical matters.

<sup>13</sup> See Internal Revenue Service, *Revised Timeline and Other Guidance Regarding the Implementation of FATCA: Notice 2013-43* (July 12, 2013); available at: <http://www.irs.gov/pub/irs-drop/n-13-43.pdf> (accessed 15 July 2013).

<sup>14</sup> Adrian Sawyer, "Assessing the Implications of the Multilateral Convention of Mutual Administrative Assistance in Tax Matters and the Foreign Account Tax Compliance Act: An Australasian Perspective", *Paper presented at the Tax Research Network Conference*, University of Exeter, September 2–4 (2013).

<sup>15</sup> Philipp Genschel and Peter Schwarz, "State of the Art: Tax Competition — A Literature Review" (2011) 9 *Socio-Economic Review* 339–370.

<sup>16</sup> *Ibid.*, at 362–363.

evidenced by European (for example, UK and Swiss agreements) and US initiatives that this paper analyses. They state:<sup>17</sup>

Perhaps most importantly, large transformation economies, such as China, India and Brazil, have recently joined the major OECD countries in their quest for tax cooperation as evidenced most clearly by strongly worded G-20 tax policy pronouncements. There is *mounting political pressure on small countries and tax havens to behave cooperatively in taxation*.

In terms of the state of ‘global tax governance’, Wouters and Meuwissen<sup>18</sup> examine the state of play concerning moves in the area of greater governance of tax policy and practice from a global perspective. With the aftermath of the GFC, international initiatives concerning tax governance have gained political momentum. The authors examine the roles and work of the G20, OECD, United Nations (UN), International Monetary Fund (IMF) and the World Trade Organisation (WTO). The authors suggest<sup>19</sup> that the OECD has engaged in a symbiotic relationship with the G20, with the IMF’s input less effective. While arguably the UN is a truly global actor, it lacks institutional capabilities in the area of taxation, and thus relies on other actors in this regard (such as the OECD). International cooperation is now the norm with respect to exchange of information and fiscal transparency. The authors comment that international standards require implementation before they become effective, stating:<sup>20</sup>

Whereas standards may be elaborated at global level, *a separate process that integrates the standards into binding agreements is necessary to translate ‘governance’ into ‘law’*. Often, binding agreements are elaborated at the regional or bilateral level, rather than at a global level.

They conclude by observing that inclusiveness will be vital to future enhancement of global tax governance.<sup>21</sup>

The gradual emergence of global tax governance is unavoidable in an ever more interdependent and globalized world. ... Today, *no fully effective and legitimate global tax policy-maker exists*. To ensure a further legitimate and effective emergence of global tax governance, specific attention should be paid to *inclusiveness of the policy processes*, vertical and horizontal interaction among the relevant fiscal authorities, implementation of policy initiatives, international oversight, and conversion from tax ‘governance’ to tax ‘law’.

While there have been numerous calls for some form of World (or International) Tax Organisation to undertake such a coordinating role, to date there is little in the way of tangible progress.<sup>22</sup> The IMF in 2010 revised the idea of a World Tax Organisation as

<sup>17</sup> Ibid, at 364 (emphasis added).

<sup>18</sup> Jan Wouters and Katrien Meusissen, “Global Tax Governance: Work in Progress?” (2011) *Leuven Centre for Global Governance Studies*, Working Paper No 59.

<sup>19</sup> Ibid, 29.

<sup>20</sup> Ibid, 30 (footnotes omitted, emphasis added).

<sup>21</sup> Ibid, 31 (emphasis added).

<sup>22</sup> See for example: Vito Tanzi, ‘Is there a Need for a World Tax Organisation?’, in Assaf Razin and Efraim Saka (eds), *The Economics of Globalisation: Policy Perspectives from Public Economics* (Cambridge University Press, 1999), 173–186; Dale Pinto, ‘A Proposal to Create a World Tax Organisation’ (2003) 9(2) *New Zealand Journal of Taxation Law and Policy* 145–160; Adrian J Sawyer, *Developing a World Tax Organisation: The Way Forward* (Fiscal Publications, 2009); Dale Pinto and



a way of energising the fight against tax evasion and avoidance.<sup>23</sup> Thus to date initiatives have been led by various organisations (such as the OECD) or major influential jurisdictions, such as the US, and the UK and Switzerland in Europe.

This paper focuses on two relatively new moves towards greater tax cooperation, the first emerging from Europe (namely the Cooperation Agreement between the UK and Switzerland), and the second being the US ‘unilateral’ FATCA initiative. This article does not extensively traverse other OECD initiatives or the Global Forum’s TIEA initiative, since the literature is extensive. Nevertheless, a brief comment is necessary to contextualize the environment.

In relation to the TIEA initiative, Soriano suggests that there appears to be little future for the TIEA unless it undergoes radical reform.<sup>24</sup> This is largely due to the OECD and Global Forum focusing on the quantity of TIEAs and less on the ‘quality’ of the signatories.<sup>25</sup> The OECD and Global Forum have yet to formally review the standard under the TIEA model and how traditionally “uncooperative” tax havens are acting under these TIEAs.<sup>26</sup> The OECD frequently promotes the TIEA model as the international standard of ineffective transparency and collaboration.<sup>27</sup> As Soriano observes<sup>28</sup>:

... a TIEA is a tool that allows banking havens to make a *show of cooperation while continuing with their essential business of selling tax evasion services to residents of rich countries*. It is a contract which cannot function if there has been no meeting of the minds, and it is *not an efficient way to address information sharing*, insofar as it cannot force domestic actors to do what they have no interest in doing. It also does not specify what is to be done if there are no appropriate domestic legal provisions to collect the information: there is no obligation to create new or quicker mechanisms to access information contained in the TIEA model.

Sawyer concludes with respect to the TIEA initiative:<sup>29</sup>

The initial focus of Global Forum was a ‘numbers game’, illustrated by the total number of TIEAs, plus minimum of 12 agreements per ‘blacklist’ jurisdiction. To be fair, there is now some qualitative analysis emerging with the Peer Review process and the release of their country reports.

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Adrian Sawyer, ‘Towards Sustaining the Future of Taxation: Is a World Tax Organisation Necessary and Feasible in Today’s Globalized World?’ (2009) 24(2) *Australian Tax Forum*, 179–205; and Dale Pinto and Adrian Sawyer, “Building Bridges Between Revenue Authorities: Would a World Tax Organisation Be a Key Facilitator?” (2011) *Journal of Applied Law and Policy*, 25–40.

<sup>23</sup> Carlo Cotarelli and Andrea Schaechter, *Long-Term Trends in Public Finances in the G-7 Economies*, IMF Staff position note, SPN/10/13, 21 (Sept. 2010), <http://www.imf.org/external/pubs/ft/spn/2010/spn1013.pdf>.

<sup>24</sup> Alberto Gil Soriano, “Toward an Automatic but Asymmetric Exchange of Tax Information: the US Foreign Account Tax Compliance Act (FATCA) as Inflection Point” (2012) 40(1) *Intertax* 540–555, 553.

<sup>25</sup> See Adrian Sawyer, “Peer Review of Tax Information Exchange Agreements: Is it *More* than just about the Numbers?” (2011) 26(3) *Australian Tax Forum*, 397–427.

<sup>26</sup> *Ibid*, 542.

<sup>27</sup> *Ibid*, 543.

<sup>28</sup> *Ibid*, 543 (references omitted and emphasis added).

<sup>29</sup> Adrian Sawyer, “The OECD’s Tax Information Exchange Agreements: An example of (in)effective global governance?” (2011) *Journal of Applied Law and Policy* 41–54, 54 (emphasis added).

TIEA ‘effectiveness’ is seriously in question. While there is a regulatory processes in place this does not necessarily guarantee effective information exchange. ... the TIEA initiative will need to undergo major revision if it is to have any realistic chance of making effective inroads to information exchange. Systematic change to the Model TIEA ... appears to be most unlikely. This leaves the question open as to whether the TIEA initiative is an expensive exercise in ‘window dressing’ that leaves tax havens with little to fear and other countries with little to gain.

Most recently, Rosenzweig suggests a new approach to encouraging tax cooperation that is working outside of tax treaties. After building his case, Rosenzweig concludes:<sup>30</sup>

The primary thesis of this Article is that the *fundamental problem with cooperation in the modern international tax regime is precisely that it builds on the tax treaty model, thus effectively excluding non-treaty member countries from the system*. Instead, this Article proposes the creation of a *non-treaty-based cooperation mechanism*, not to rule on which country should be entitled to tax a particular item of income as an economic matter, but rather to *focus primarily on the mission of overcoming the modern collective action problem facing the international tax regime*. Building a tax cooperation mechanism specifically around the premise of *incentivizing cooperation of the least cooperative states in this manner could harness the same forces that led to the emergence of the modern international tax regime in the early twentieth century to address the fiscal crisis facing the early twenty-first century, thereby making all countries better off: poorer countries through winning specific disputes and wealthier countries through increased international tax cooperation*.

This brief review does not purport to be comprehensive in terms of the breadth of global and regional initiatives directed at enhancing tax cooperation,<sup>31</sup> nor does it systematically examine in depth the initiatives highlighted in the discussion.<sup>32</sup> The paper does not explore other matters, such as concerns over governance and the impact that tax secrecy has on tax morale. Nevertheless, in the context of tax morale, efforts to enhance the exchange of information encourage taxpayer compliance, whereas the reverse may give an impression of legitimising tax evasion and avoidance through failing to encourage taxpayers to declare their income.<sup>33</sup> An in-depth discussion would not serve the objectives of this paper, namely to focus on two major initiatives that have implications for tax cooperation within the UK, Europe (focussing on Switzerland) and the US. The article now turns to providing a brief background to the UK and Swiss Tax Cooperation Agreement.

<sup>30</sup> Adam H Rosenzweig, “Thinking Outside the (Tax) Treaty” (2012) *Wisconsin Law Review* 717–786, 783–784 (emphasis added).

<sup>31</sup> For a recent proposal for enhancing tax cooperation, see H David Rosenbloom, Noam Noked and Mohamed S Helal, “The Unruly World of Tax: A Proposal for an International Tax Cooperation Forum” (2014) 15(2) *Florida Tax Review* 57–86.

<sup>32</sup> For further analysis of developments in exchange of information in the EU, see Roman Seer, “Recent Development in Exchange of Information within EU for Tax Matters” (2013) 22(2) *EC Tax Review* 66–77.

<sup>33</sup> See for example, James Alm and Beno Torgler, “Culture Differences and Tax Morale in the United States and in Europe” (2006) 27 *Journal of Economic Psychology* 224–246.

### 3. THE SWITZERLAND – UNITED KINGDOM TAX COOPERATION AGREEMENT

As noted earlier, signing of the Swiss Confederation-UK Taxation Cooperation Agreement occurred on 6 October 2011, and came into effect on 1 January 2013. The object of this agreement is to provide for bilateral cooperation between the UK and Switzerland to ensure the effective taxation in the UK of relevant persons.<sup>34</sup> The focus of the agreement is both to regularise the past (through a one-off payment to clear tax liabilities), and to create a regular withholding mechanism for income and gains on an ongoing basis.<sup>35</sup> The Cooperation Agreement also seeks to encourage voluntary disclosure by UK domiciled and non-domiciled resident taxpayers,<sup>36</sup> and provides for administrative matters, such as processes for handling the requests for information, transfer of assets and payments, an expense allowance for Switzerland and audits of Swiss paying agents.

In relation to the Cooperation Agreement, the House of Commons Treasury Committee (Treasury Committee) expressed concern over the apparent favourable treatment of those with Swiss assets over other taxpayers. Of major concern was the fact that the withholding rates applied to income and capital is lower than the top UK rates.<sup>37</sup> HMRC's David Hartnett responded:<sup>38</sup>

The 48% is a calculation based on the top rate of 50% when money would often not come in, or generally not come in, until 31 January following the end of the tax year. This money will come in earlier, so we calculated a withholding based on that anticipation of money.

The Treasury Committee correctly observed that this logic does not apply to domestic withholding rates on UK income, such that they will vary depending upon the time of withholding of tax or payment of the tax following the filing of a return. The Treasury Committee then observed:<sup>39</sup>

55. Any perception that those with offshore accounts are paying lower taxes than compliant taxpayers creates a *risk that the agreement may encourage taxpayers to seek opportunities to evade tax in the belief that they will be able to reach a favourable settlement in future*. Also, any perception that

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<sup>34</sup> See note 1, above, Article 1.

<sup>35</sup> The Cooperation Agreement originally provided for interest income, dividends and other income, plus capital gains. VAT is also included. It now includes inheritances and excludes interest income.

<sup>36</sup> Details on the process for non-domiciled individuals are available in an HMRC advice: UK–Swiss Confederation Taxation Cooperation Agreement: remittance advice (11 December 2012); Legislative changes will be included in the Finance Bill 2013 through introducing a new section 26A to Schedule 36 of the Finance Act 2012; see further on HMRC's website. It is anticipated that over 265,000 British citizens living in Hong Kong could be affected by the Cooperation Agreement. According to Democratic Party lawmaker, James To Kun-sun, "people would rather choose to disclose and argue with the government, hoping that some money would turn out not to be taxed." This would be preferred over facing penalties. See Simpson Cheung, "Long arm of UK taxman reaches city", *South China Morning Post* (25 February 2013).

<sup>37</sup> House of Commons Treasury Committee, "Closing the Gap: HMRC's record at ensuring compliance", *29<sup>th</sup> Report of the Session 2010-12 HC 1371* (March 2012); available at: <http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1371/1371.pdf> (accessed 4 March 2013).

<sup>38</sup> *Ibid*, at 15.

<sup>39</sup> *Ibid*, at 15 (emphasis added).

some taxpayers are receiving more favourable treatment than others is likely to discourage voluntary compliance.

This observation is in accordance with the behavioural tax compliance literature, such that fairness perceptions are critical to encouraging compliance.<sup>40</sup> The Treasury Committee went on to recommend that:<sup>41</sup>

... HMRC, when publicising the UK-Swiss tax agreement, *explains clearly the reasons for the lower rates of tax being withheld from Swiss bank accounts*. If there are to be similar agreements in future with other jurisdictions, the Government should seek agreement for the same effective tax rates that apply to UK taxpayers.

However, modifications to the original agreement occurred by way of a protocol on 20 March 2012.<sup>42</sup> This protocol clarifies the relationship between the Cooperation Agreement and the European Union's Savings Agreement (EUSA) with Switzerland.<sup>43</sup> The Protocol was necessary to ensure the Cooperation Agreement is in accordance with the EUSA. Consequently, where a relevant person has incurred a withholding tax under the EUSA (instead of a withholding tax on their interest payment under the Cooperation Agreement), an additional 13 per cent 'tax finality payment' needs to be paid to obtain tax clearance under the terms of the Cooperation Agreement. This achieves the same effect as the 48 per cent withholding tax levied under the original terms of the Cooperation Agreement. The protocol also introduces a new Inheritance Tax levy on the death of the relevant person unless their personal representatives authorise the Swiss bank to disclose the account details to the UK. This was an oversight in the original Cooperation Agreement. Overall the rates are based on the relevant tax rates applicable in the partner states in order to prevent a distorting effect of tax competition.

The EU Savings Directive, which the UK Government supports, aims to counter cross-border tax evasion by collecting and exchanging information about foreign resident individuals receiving savings income outside their resident state. EU

<sup>40</sup> See, for example, the literature review by Maryann Richardson and Adrian Sawyer, "A Taxonomy of the Tax Compliance Literature: Further Findings, Problems and Prospects", (2011) 16(2) *Australian Tax Forum*, 137–320.

<sup>41</sup> House of Commons Treasury Committee, above n 37, 15 (emphasis added).

<sup>42</sup> *Protocol Amending the Agreement between the Swiss Confederation and the United Kingdom of Great Britain and Northern Ireland on Cooperation in the Area of Taxation* (London, 20 March 2012). The UK has also declared that it will not actively seek to acquire customer data stolen from Swiss banks, and HMRC has clarified its position with respect to criminal investigations of relevant persons.

<sup>43</sup> See European Council, *Directive on taxation of savings income in the form of interest payments*, Directive 2003/48/EC (2003); and European Council and Swiss Confederation, *Agreement between the Swiss Confederation and the European Community providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments* (26 October 2004). This agreement protects the secrecy of bank clients while ensuring that interest income is taxed by way of a withholding tax payable to EU member countries. EU nations can choose between the Swiss retention tax and making a voluntary declaration to their home tax authority. On 14 May 2013, the European Commission announced that Switzerland, amongst other European nations, has agreed to negotiate a stronger savings tax agreement with the EU; see Algirdas Šemeta, "Press conference remarks at Council of Finance Ministers (May 14, 2013). For a discussion on the strengths and weaknesses of the EU Savings directive, see Tyler J Winkelman, "Automatic Information Exchange as a Multilateral Solution to Tax Havens" (2012) 22 *Indiana International and Comparative Law Review* 193, 204–208. Under the EU Savings Directive, Switzerland has made the following payments: CHF510 million in 2013, CHF615.4 million in 2012, CHF506.5 million in 2011; CHF432 million in 2010 and CHF534.8 million in 2009.

members are required to make the necessary legislative changes within their jurisdiction to enable the EU Savings Directive to operate effectively. Consequently, HMRC collects information about the payment of savings income to certain overseas residents and exchanges this with certain other countries in the EU. With Switzerland not being a member of the EU, a separate agreement between the EU and Switzerland was necessary.<sup>44</sup> Similarly, the UK negotiated the Cooperation Agreement with Switzerland.

Later on 18 April 2012, the UK exchanged letter with Switzerland informing that it wished to exercise its right to have a beneficial change in the Cooperation Agreement to match that in the Swiss Federation-Federal Republic of Germany Taxation Cooperation Agreement.<sup>45</sup> This exchange of letters increased the minimum rate from 19 to 21 per cent, and altered the graduated rate formula applied to such assets.

The Cooperation Agreement, as amended, became part of UK domestic law by way of introducing Schedule 36 to the Finance Act 2012.<sup>46</sup> HMRC is encouraging UK taxpayers to choose to make a voluntary disclosure rather than do nothing and have a one-off payment deducted from their Swiss assets.<sup>47</sup> When choosing the voluntary disclosure option, this may be to HMRC directly, through the Liechtenstein Disclosure

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<sup>44</sup> Ibid, (2004 Agreement). On 9 October 2013, the Swiss Federal Council adopted a draft mandate for negotiations regarding a revision of the taxation of savings agreement concluded with the EU. These negotiations had been held up pending a satisfactory solution being found with respect to how the regulation of third country regimes is structured for the provision of cross-border financial services. The draft mandate, prepared by the Federal Department of Finance in collaboration with the Federal Department of Foreign Affairs, will be submitted for consultation to the competent parliamentary committees and to the cantons. The Federal Council will then adopt the definitive mandate, whereupon Switzerland will be able to commence negotiations with the EU.

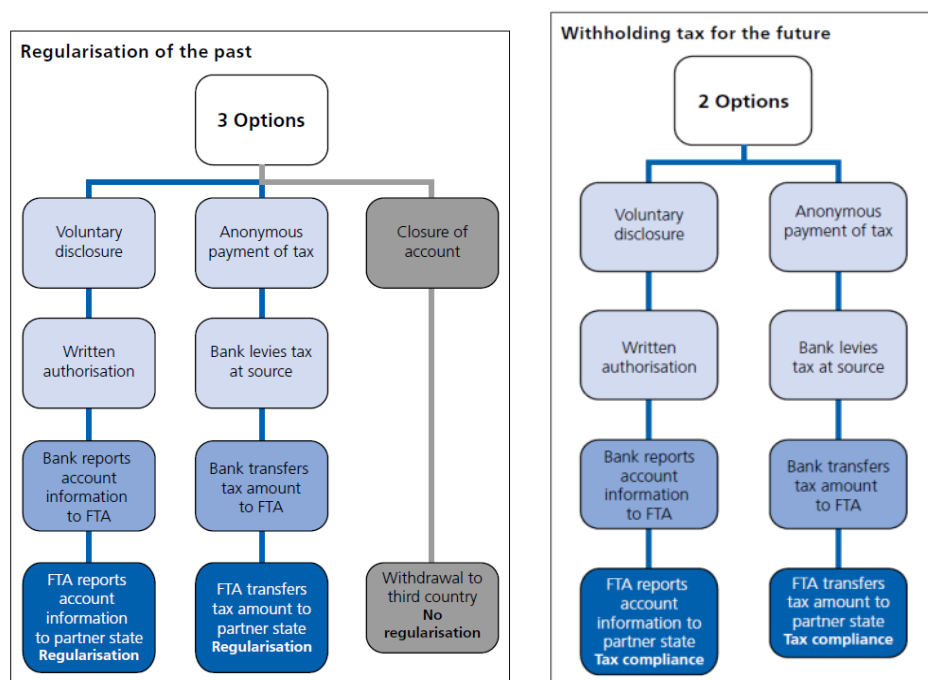
<sup>45</sup> *Agreement between the Swiss Federation and the Federal Republic of Germany on Cooperation in the Area of Taxation* (Berlin, 21 September 2011); as amended on 5 April 2012. See the Mutual Agreement representing the Exchange of Letters of 18 April signed in Berlin (for Swiss Confederation) and in Zurich (for the UK). This agreement was expected to raise €10 billion according to German authorities. The German agreement failed to be ratified by the Upper House (the opposition Social Democratic Party believed the agreement was too lenient and would not support it) and therefore has not come into effect. Indeed, Associate Professor Itai Grinberg testified before the Finance Committee of the German Bundestag against the proposed agreement between Germany and Switzerland; see Itai Grinberg, "Anonymous Withholding Agreements and the Future of International Cooperation in Taxing Foreign Financial Accounts: Testimony before the Finance Committee of the German Bundestag" (2012), *Georgetown University Law Centre* paper. In June 2014, Switzerland announced it was in negotiations to widen its cooperation with France for the exchange of information. This follows a long running dispute over inheritance tax for wealthy French citizens living in Switzerland; see Denis Balibouse, "Swiss agree to widen cooperation with France on tax evasion" (June 25, 2014) *Reuters News* (accessed 8 July 2014). An agreement between Switzerland and Austria has been negotiated; see *Agreement between the Swiss Federation and the Federal Republic of Austria on Cooperation in the Area of Taxation* (12 April 2012). This agreement was expected to raise €1 billion. For an analysis of the 'failed' German agreement, see Ernst and Young, *Agreement between the Swiss Confederation and the Federal Republic of Germany*" (2012) *Tax News* (March) 8–11. A comparison of the Austrian and UK agreements suggests that the UK negotiated a much more potent agreement, including the advance payment of CHF 1.3 billion by 31 May 2013 (Austria no such payment) and a maximum of 500 enquires each year (Austria none). Other variations reflect the main differences between the tax systems in the two countries. The potential fallout from the failure of the German agreement to receive ratification has been largely muted with the UK ratifying its agreement with Switzerland.

<sup>46</sup> Schedule 36, *Agreement between UK and Switzerland, Finance Act 2012*. Schedule 36 provides for the past situation, the future (with respect to income tax, capital gains and the inheritance tax, and general provisions).

<sup>47</sup> HMRC, *The Swiss/UK Tax Cooperation Agreement and HM Revenue & Customs (HMRC): Fact Sheet*, (October 2012); available at <http://www.hmrc.gov.uk> (accessed 4 March 2013).

Facility (LDF),<sup>48</sup> or by way of an HMRC Contractual Disclosure Facility (CDF), which may be applicable in cases of fraud.<sup>49</sup> The LGT Bank Ltd (based in Liechtenstein), provides an excellent comparison of the LDF versus the Cooperation Agreement and concludes that the LDF has advantages over the Cooperation Agreement in terms of reduced risks for UK resident taxpayers, and potentially lower penalties.<sup>50</sup> The Cooperation Agreement works as follows in Figure 1:<sup>51</sup>

**Figure 1: The Swiss-UK Cooperation Agreement: The two approaches**



The two diagrams illustrate the process to regularise the past and for the withholding tax to apply in the future. Swiss banks will deduct a flat-rate tax sum on existing assets from UK clients (the past) and on investment income and capital gains (the future), respectively, and forward this sum to the Federal Tax Administration (FTA) in

<sup>48</sup> *Memorandum of Understanding Between the Government of the Principality of Liechtenstein ("Government of Liechtenstein") and Her Majesty's Revenue and Customs ("HMRC") of the United Kingdom of Great Britain and Northern Ireland relating to Cooperation in Tax Matters* (Vaduz, Liechtenstein, 11 August 2009). Details of the LDF and associated issues are available on the HMRC website at: <http://www.hmrc.gov.uk/disclosure/liechtenstein-faq.htm> (visited 4 March 2013). The LDF was launched in 2009 and runs now until April 2016 (it originally was due to finish in 2015). It supports the review carried out by the financial intermediaries in Liechtenstein to identify person who may have a liability to UK taxation. A Joint Declaration of 11 August indicated discussions were underway towards negotiating a DTA between the UK and Liechtenstein. A Third Joint Declaration of 11 June 2012 confirmed that a DTA had been signed which supplements the 11 August TIEA (the Memorandum of Understanding).

<sup>49</sup> Details of the CDF are available on HMRC's website at: <http://www.hmrc.gov.uk/admittingfraud/help.htm> (accessed 4 March 2013).

<sup>50</sup> LGT Bank Ltd, *LDF vs Agreement UK-CH* (23 January 2013); available at: [http://www.disclosure-facility.co.uk/export/sites/inta\\_ldfinfo/en/dl/LDF-versus-UK-CH-Agreement\\_en.pdf?DSCext.nav\\_type=3](http://www.disclosure-facility.co.uk/export/sites/inta_ldfinfo/en/dl/LDF-versus-UK-CH-Agreement_en.pdf?DSCext.nav_type=3) (accessed 4 March 2013).

<sup>51</sup> The Federal Council, *Report on International Financial and Tax Matters 2013* (January 2013), 33 and 34; available at <http://www.efd.admin.ch> (accessed 4 March 2013). This is a translated document from the original Swiss language.

Switzerland. The FTA will transfer the tax to the UK's HMRC. With this transfer, the tax liability is fully settled, and thus is a final withholding tax. This protects the privacy of bank clients and the UK HMRC receives tax payments that it is entitled to by law. The critical date for Swiss bank clients to make their decisions concerning disclosure or closing their accounts early was 31 May 2013. Overall, the aim is to encourage early disclosure through a lower withholding tax rate.

When comparing the Cooperation Agreement to the LDF, it is important to recognise that the agreement between the UK and Switzerland had to be sufficiently practical to enable Swiss paying agents to administer it. Furthermore, conclusion of the Cooperation Agreement is on entirely different principles to the LDF. The LDF is a comprehensive disclosure opportunity based upon meeting certain conditions. The aims of the Cooperation Agreement, however, are to address the issue of non-compliant assets held or managed by Swiss paying agents for UK residents, and to introduce a mechanism to ensure future income and gains from these assets are subject to disclosure or to a withholding tax, set at a level which reflects the top UK rates. Consequently, it is not really a disclosure facility.<sup>52</sup> As Rawlinson and Hunter suggest, "... it could be described as a combination of an enhanced EU Savings Tax and an exchange of information agreement."<sup>53</sup>

As KPMG comment, for many UK taxpayers, the LDF is still likely to be the most appropriate (and cheaper) route.<sup>54</sup> Why is this so? The key benefits of the LDF are what appears to be a guaranteed immunity from prosecution, the use of a composite rate option (which KPMG suggest can reduce the size of the tax liability substantially), being able to resolve worldwide-undisclosed assets and achieving certainty for the future.

If UK taxpayers transfer all or some of their Swiss accounts, this will not necessarily relieve them from their tax liability. Emphasising the consequences of this new environment, when announcing the new Cooperation Agreement, HMRC Permanent Secretary for Tax Dave Hartnett, stated:<sup>55</sup>

The world is shrinking fast for offshore tax evaders and this agreement will ensure that we know where money that flees Switzerland is heading. We won't be far behind.

<sup>52</sup> Nevertheless, as of 12 June 2012, the LDF led to more than 2,400 UK taxpayers sign up, bringing in £363 million to HMRC; see Randall Jackson, "UK-Liechtenstein Tax Disclosure Scheme Successful" (2012) 66 *Tax Notes International* (June 18) 1115–1116. Dave Hartnett is reported as stating that HMRC expects the LDF to produce up to £1.3 billion from a much larger number of people. HMRC to February 2014 has received £914 million under the LDF, and expects now to receive £1.4 billion by April 2016 under the LDF. See Helen Burggraf, "LDF yield could be less than half of £3 billion target" (2014) *International Advisor* (3 April); available at: <http://www.international-advisor.com/news/tax-regulation/ldf-tax-yield-could-be-less-than-half> (accessed 8 July 2014).

<sup>53</sup> Rawlinson & Hunter, "UK/Swiss Tax Agreement — A Detailed Summary" (2011) *Briefing* (November), 1.

<sup>54</sup> KPMG, *UK-Switzerland Tax Cooperation Agreement* (2013); available at: <http://www.kpmg.com/uk/en/services/tax/personaltax/pages/uk-switzerland-agreement.aspx> (accessed 8 March 2013).

<sup>55</sup> David D Stewart, "UK, Switzerland Agree to Withholding Tax Plan" (2011) 64 *Tax Notes International* (October 17) 167–168, 167 (quoting Dave Hartnett).

On 14 November 2012, Secretary of the UK Exchequer stated:<sup>56</sup>

The days of hiding money in Switzerland in order to evade tax are over. Burying your head in the sand is no longer an option. The only realistic strategy is to talk to HMRC, as quickly as possible.

Early forecasts for revenue under the Cooperation Agreement by the UK Treasury were in the range of £4 billion to £7 billion. Consequently, the net revenue impact for the UK is substantial, although the range is surprisingly variable, suggesting the UK Treasury has little idea of the size of assets held in Switzerland by UK residents. During January 2013, Swiss authorities made an initial payment of £342 million (SFr500 million) to the UK Government as part of an advance payment to May 2013.<sup>57</sup> Another £547 million (SFr800 million) was initially considered to be outstanding, with the total to be reimbursed to the Swiss banks once the equivalent of SFr1.3 billion (£899 million) is reached.<sup>58</sup> However, any further (advance) payments are likely to be less than initially expected as more account holders are voluntarily revealing their accounts and many UK residents are not UK domiciled and thus not liable to UK tax.<sup>59</sup> Total payments from July 2013 to June 2014 as part of the regularisation of untaxed assets amount to £466.8 million, with £10 billion in disclosed assets. For final withholding tax on capital income, the payments for the 2013 calendar year total £58.2 million.<sup>60</sup>

Johannesen has attempted to empirically measure the reduction in Swiss bank deposits induced by the EU Savings Directive.<sup>61</sup> While not specifically including the Cooperation Agreement, the findings indicate a 30–40% reduction in Swiss bank deposits held by EU residents. Furthermore, rather than greater compliance, Johannesen's research reveals that Swiss deposit holders have substituted untaxed alternatives for their Swiss deposits. Assuming a similar reaction under the Cooperation Agreement, this would suggest a reduction in UK resident holding Swiss accounts (part of the aim of the Cooperation Agreement), but also some substitution to untaxed alternatives rather than necessarily leading to enhanced compliance in the longer run.

After receipt of the first payment, Chancellor of the Exchequer, George Osborne, during the House of Commons Question Time on 29 January 2013, is reported as stating:<sup>62</sup>

<sup>56</sup> HMRC Press Office, "Decision time for Swiss account holders" (2012) *Press Release* (14 November); available at: <http://hmrc.presscentre.com/Press-Releases/Decision-time-for-Swiss-account-holders-68347.aspx> (accessed 4 March 2013).

<sup>57</sup> Office for National Statistics (UK), *Public Sector Finance: January 2013* (February 21, 2013), 13. See also Swissinfo.ch, "British receive initial funds from tax deal" (January 30, 2013); available at: [http://www.swissinfo.ch/eng/politics/British\\_receive\\_initial\\_funds\\_from\\_tax\\_deal.html?cid=34867206](http://www.swissinfo.ch/eng/politics/British_receive_initial_funds_from_tax_deal.html?cid=34867206) (accessed 4 March 2013).

<sup>58</sup> See Swissinfo.ch, *ibid.* Austria does not receive a similar upfront payment, and with the German Senate rejecting a similar deal, it will not receive any payments under a Rubik accord.

<sup>59</sup> Society of Estate and Trust Practitioners, "Swiss banks' guarantees to UK government may have been too generous" (July 2013); at <http://www.step.org> (accessed 8 July 2014).

<sup>60</sup> Swiss Federal Tax Administration, *Payments to the UK* (2014); available at: <http://www.estv.admin.ch/intsteuerrecht/aktuell/index.html?lang=en> (accessed 8 July 2014).

<sup>61</sup> Niels Johannesen, "Tax evasion and Swiss bank deposits" (2014) 111 *Journal of Public Economics* 46–62.

<sup>62</sup> David D Stewart, "UK Announces First Payment under Swiss Tax Agreement" (2013) 69 *Tax Notes International* (February 4) 448 (emphasis added).



I can confirm to the House that last night Her Majesty's Revenue and Customs received £340 million from the Swiss Government, a first instalment of the deal we have struck, and *the first time in our history that money due in taxes has flowed from Switzerland to the U.K., instead of the other way round.*

Exchequer Secretary David Gauke stated on 29 January 2013, that “... [o]ur agreement with the Swiss Government will deliver around £5 billion of previously unpaid tax to the UK.”<sup>63</sup> As part of the UK Government's decision to review its future involvement in the EU as to what continued involvement would mean for the UK national interest, HM Treasury released a consultation paper in November 2012. Taxation is one area of relevance to this review, with HM Treasury outlining the restrictions imposed on the UK by its EU membership, but also outlining the scope for entering into its own agreements.<sup>64</sup>

Grinberg comments on the tensions and inconsistencies with the UK decision to enter into the agreement with Switzerland, observing:<sup>65</sup>

*The Swiss-U.K. agreement sits in uncomfortable tension* with Chancellor of the Exchequer George Osborne's April 2013 agreement to “work on a pilot multilateral exchange facility... using the model agreed with the US” with France, Germany, Italy and Spain (the “G5 Proposal”). It also is *inconsistent with HM Revenue and Customs' (HMRC) claims* that the UK will pursue bilateral agreements consistent with the UK-US FATCA IGA, and the G20's April 19, 2013 agreement to work toward a new international standard of automatic information exchange.

*The internal contradictions of UK policy are important*, because the UK's overseas territories and crown dependencies are, in the aggregate, enormously important managers of offshore wealth. ... Furthermore, the *UK has asserted substantial control of the negotiations regarding the process and rules under which information on US accounts held in UK overseas territories crown dependencies pass to the United States.* By asserting that control, the U.K. gains greater influence over the shape of a future global settlement on information exchange.

From a Swiss perspective, the Federal Council released a report in January 2013 on financial and tax developments in 2012.<sup>66</sup> In this report Switzerland indicates that it is prepared to sign agreements that respect the privacy of bank clients while ensuring

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<sup>63</sup> Ibid.

<sup>64</sup> HM Treasury, *The Government's review of the balance of competencies between the United Kingdom and the European Union* (November 2012). HM Treasury states (p 21, footnotes removed): “3.63 Member States are themselves able individually to conclude tax agreements with other EU countries or non-EU countries through intergovernmental arrangements. For example, this may be done bilaterally in the form of a Double Tax Treaty, of which the UK has over 100, a Tax Information Exchange Agreement, including the UK-US Intergovernmental Agreement to Improve International Tax Compliance and to Implement FATCA, or agreements like the UK-Swiss Tax Agreement. Alternatively, agreements may be effected multilaterally, such as in the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.”

<sup>65</sup> Grinberg, above n 6, 20 (footnotes omitted, emphasis added).

<sup>66</sup> The Federal Council, above n 51, 32–38.

that legitimate tax claims of Switzerland's partner countries are implemented.<sup>67</sup> This is part of a new era for Switzerland (the beginning of a 'thaw' in its traditional banking and associated tax secrecy), in which it has over 40 DTAs containing the new administrative assistance provisions. Switzerland draws attention to it agreeing with the UK to allowing UK tax authorities to submit requests for information that contain the name of the client but not necessarily the name of the bank. The number of requests is subject to an annual limit (currently 500 requests). Reasonable grounds need to form the basis for such requests.<sup>68</sup> It is important to note that, since the Cooperation Agreement affects everyone who is liable to tax in the UK regardless of his or her nationality, it also affects UK-resident Swiss nationals.

Switzerland, having faced pressure from numerous jurisdictions (including the US) following the GFC to assist them in reducing tax evasion, wishes to achieve its objective of being a tax-compliant financial centre. In this regard, it is concluding withholding tax agreements (such as the Cooperation Agreement), improving administrative and mutual assistance in accordance with international standards and extending financial institutions' due diligence requirements. The Swiss Federal Department of Finance states:<sup>69</sup>

From the Swiss perspective, the *final withholding tax is preferable to the automatic exchange of bank data*. Switzerland forwards the tax owed directly to the country concerned and at the same time *protects clients' privacy*. Moreover, the Confederation will continue also in the *future to provide administrative assistance in tax matters in accordance with the OECD standard*. The prerequisite for this assistance is a corresponding double taxation agreement with the enquiring country.

The Tax Administrative Assistance Act 2012 (TAAA) came into force on 1 February 2013, replacing the former Ordinance on Administrative Assistance of October 2010 in relation to various DTAs.<sup>70</sup> The TAAA now governs the provision of administrative assistance under DTAs and other agreements for the exchange of

<sup>67</sup> Ibid, 32. The Report overviews Switzerland's efforts at bilateral cooperation through entering into DTAs and TIEAs, the process by which it now implements such agreements into its domestic law (the Tax Administrative Assistance Act 2012), international withholding tax agreements (such as the Cooperation Agreement), agreements with the US such as FATCA, and agreements with the EU. Multilateral cooperation initiatives include the Global Forum on Transparency and Exchange of Information for Tax Purposes and working with the UN.

<sup>68</sup> Federal Council, above n 51, 34–35. Furthermore, within one year of the date it comes into force (1 January 2014), the Swiss government will report the 10 jurisdictions to which UK residents transferred the largest volume of undeclared assets.

<sup>69</sup> Federal Department of Finance, *Withholding Tax Agreements* (January 2013), 2 (emphasis added). There is reference to a Federal Act on International Withholding Tax (IWTa) that contains provisions on organisation, procedure, judicial channels and the applicable criminal law provisions. This Act came into force on 20 December 2012. It entered into force ahead of the bilateral agreements to ensure that the upfront payment by Swiss paying agents set out in the agreement with the UK can be transferred to the UK by the deadline of 31 January 2013. No English equivalent has been located, but in translating from German, its full title is the *Federal Law about the International Withholding Tax 2012*. Negotiations are currently underway with Greece and Italy for similar agreements. More recently Switzerland and the EU have a serious disagreement over cantonal company tax practices in Switzerland, with Switzerland emphasising that since there is no agreement between Switzerland and the EU requiring the EU to harmonise its corporate taxes there can be no violation. Since Switzerland is not part of the EU single market, the EC Treaty competition rules do not apply to Switzerland; see Federal Department of Finance, *Switzerland — EU Tax Controversy* (2011).

<sup>70</sup> The full title is: *Federal Act on International Administrative Assistance in Tax Matters (Tax Administrative Assistance Act, TAAA) 2012*. The TAAA was passed into law in September 2012.

information in tax matters (such as TIEAs and the Cooperation Agreement) with respect to both foreign and Swiss requests for administrative assistance. Under the TAAA, the provision of administrative assistance requires a specific request. Importantly, the Cooperation Agreement permits group requests; however, requests that come without concrete indications will not, (such as requests made for the purposes of ‘fishing’). Furthermore, Switzerland will not meet requests for information based on information obtained through actions punishable under Swiss law, such as the illegal acquisition of data. The TAAA also sets out who is to be informed about pending requests and to whom a right to participation and inspect files is provided. There is also an appeal procedure, including the potential for a second appeal body.<sup>71</sup>

More recently Switzerland’s decision in October 2013<sup>72</sup> to sign the OECD’s Multilateral Convention represents a significant step to bringing exchange of information closer to the new emerging standard of automatic exchange.<sup>73</sup> Once ratified, this may serve as the litmus test of how far Switzerland’s ‘thaw’ may potentially go with respect to facilitating information exchange. This is expected to challenge Switzerland, in the view of the OECD in its economic survey of Switzerland published November 2013. Patel is reported as stating that Switzerland is struggling with maintaining a delicate balance, namely:<sup>74</sup>

Switzerland is grappling with the [information exchange] needs for certain jurisdictions while preserving its historical business. ... It is trying to appease the Western world while courting business from the rest of the world. ... How do you sell banking secrecy services while turning over data to the U.S., U.K., and Germany? ... The model of selling confidentiality, but not being a tax haven, really doesn’t work.

Overall Switzerland is seeking to be much more cooperative with other countries with regard to taxation. Switzerland’s involvement in various international bodies illustrates this in part. This includes the OECD (a founding member in 1961), the Global Forum on Transparency and Exchange of Information for Tax Purposes (a member since 2009), the Intra-European Organisation of Tax Administrations (IOTA – a member since 2006), the UN, the International Fiscal Association, and the recent TAAA that gives effect to enhanced cooperation.<sup>75</sup> The actions by Switzerland have also made the EU much more eager to negotiate a comprehensive EU-wide tax agreement with Switzerland, rather than have the UK in particular benefit from being ‘first off the mark.’

In commenting on the Cooperation Agreement in relation to UK domiciled taxpayers, Johnson questions whether it will have any real teeth.<sup>76</sup> He raises the very real matter of whether a person would hold an account in their name and rely solely on Swiss

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<sup>71</sup> State Secretariat for International Financial Matters SIF, *Tax Administrative Assistance Act* (October 2012); available at <http://www.sif.admin.ch> (visited 4 March 2013). The TAAA provides for appeals under the Swiss Administrative Procedure Act 1968(SR 172.021) applies.

<sup>72</sup> OECD, above n 8. As noted earlier Switzerland has yet to enact ratifying legislation.

<sup>73</sup> OECD, above n 9.

<sup>74</sup> Randall Jackson, “Information Exchange will challenge Switzerland, OECD says” (2013) 72 *Tax Notes International* 717–718, at 717–718.

<sup>75</sup> See Federal Department of Finance, *Switzerland’s engagement in international bodies that deal with tax matters* (November 2012).

<sup>76</sup> Trevor Johnson, “The Swiss-UK Tax Agreement: The Fiscal Equivalent of Emmental Cheese” (2011) 64 *Tax Notes International* (December 5) 717–719.

secrecy to avoid detection. It would be expected that some form of intervening structure (for example, trusts or companies) would be in place to ‘muddy the water’, since the Cooperation Agreement does not extend to accounts held by trustees or companies. Johnson also points out that HMRC is entirely reliant on the Swiss paying agents to carry out their role under the agreement and has no sanction available to levy in the case of failure. Johnson also recommends using the LDF rather than the Cooperation Agreement when making disclosures. He makes two further telling points:<sup>77</sup>

*Is it morally right to allow someone to continue to submit an incorrect tax return and give them a tax discount into the bargain? In the current climate even professional tax advisers are beginning to feel uncomfortable with this agreement. ...*

This agreement has been criticized from all quarters. Some advisers say that it is not attractive enough to the tax evader, who would be better advised using the LDF instead. Others are claiming that evaders are being let off lightly. I think both sides have merit in their arguments and some rewriting of the agreement needs to be carried out before it comes into force.

In relation to non-domiciled UK residents, Johnson suggests only those that have been declaring remittance of some but not all of their non-UK income and gains would benefit from using the provisions of the Cooperation Agreement.<sup>78</sup> In fact non-domiciled individuals have a greater range of choices available to them, provided they come within this category. Johnson states:<sup>79</sup>

It seems clear that the agreement as it stands is not perfect — no compromise ever is. The Swiss concerns about banking confidentiality have had to be balanced with the UK’s needs to raise more tax. It is a pragmatic approach that is not going to please everyone, and that includes our European friends. ...

However, it does not seem to be the scope of the UK agreement that has rattled the cages of the European Commission, but rather the fact that the U.K. (and Germany) has gone off and “done its own thing.” It *therefore boils down to a question of sovereignty, which is something of a hot potato in EU-UK relations*. The potential dispute is not going to make for an easy decision for those with a few undeclared millions tucked away in Zurich.

While now more of historical interest only, an editorial in the UK’s *Financial Times* came out strongly against the Cooperation Agreement, stating:<sup>80</sup>

The rejection of a tax agreement with Switzerland by the upper house of Germany’s parliament is a welcome opportunity to *revisit a deal that was too lenient on tax evaders and those who aid and abet them*. The UK and

<sup>77</sup> Ibid, 719 (emphasis added). Apart from the amendments discussed earlier, there has been no substantial rewriting of the Cooperation Agreement.

<sup>78</sup> Trevor Johnson, “More Holes in the Emmmental: A Continuing Look at the Switzerland-UK Tax Agreement” (2011) 64 *Tax Notes International* (December 12), 801-803.

<sup>79</sup> Ibid, 802-803 (emphasis added).

<sup>80</sup> Editorial, “Swiss bank secrecy comes under scrutiny” (2012) *Financial Times* (November 30); as reported by Tax Research UK at: <http://www.taxresearch.org.uk/Blog/2012/11/30/the-ft-says-its-time-to-scrap-the-uk-swiss-tax-deal-because-it-grants-cheats-a-privilege/> (emphasis added).

Austria, which have struck similar deals with Bern, should also see the virtues of a tougher approach.

The deals are all cast in the same mould: *the countries' own tax authorities abdicate their task to Swiss banks*, which will charge anonymous account holders a one-off fee on assets deposited in the past and a regular withholding tax on future income. This money – but not information about the owners' identities – will flow back to the national treasuries to which the taxes were originally owed.

This is better than nothing, even if it may not make back what was originally owed. The sanctioning of anonymity, however, breaches a basic principle: not to grant cheaters a privilege – the ability not to declare their taxable income or assets to the proper authorities – denied to those who play by the rules. This is an injustice in its own right. It also raises the question of how the new agreement can be trusted to work in practice.

Grisel and Gani review the dramatic change in the Swiss policy regarding the exchange of information in tax matters that occurred on 13 March 2009.<sup>81</sup> On this day, Switzerland 'gave up' its traditional restrictive approach, and commenced renegotiating DTAs that adopt the OECD's standard with respect to exchange of information. Consequently, the authors observe that the clients of the Swiss banks are no longer guaranteed quasi-absolute bank secrecy towards their residence country's tax authorities. Grisel and Gani examine the Swiss bank secrecy and its recent evolutionary changes, and focus their analysis on effects this may have on accounts held in trust. They conclude that, to an extent, in certain circumstances trusts may be a barrier against exchange of information between Switzerland and foreign tax authorities.

From a Swiss perspective, Toenz and Krech make the following observation:<sup>82</sup>

These two special tax agreements are *good for the contracting states as they satisfy the interests and requirements of the contracting states equally well*. They respect the protection of bank clients' privacy applicable in Switzerland and also ensure the recovery of unpaid taxes from offshore accounts both for the past and the future.

However, the agreements are very complex indeed and comprise some 32 pages. They impose significant responsibilities on the Swiss financial institutions as well as on the UK or German resident taxpayer, and the time frames within which important decisions must be made are very short. However, *any option chosen by a relevant person to regularize the past has no impact on options available for the future regarding the potential withholding tax on income and gains on relevant assets levied by Swiss paying agents*.

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<sup>81</sup> Guillaume Grisel and Raphael Gani, "Swiss bank accounts held in trust: the Swiss bank secrecy reborn?" (2012) 18(5) *Trust and Trustees* 412–414.

<sup>82</sup> Leonard Toenz and Katja Krech, "Switzerland's Tax Cooperation Agreements with the UK and Germany – Regularizing the Past" (2012) 65 *Tax Notes International* (March 5), 757–759, 759 (emphasis added). For a commentary on the changes brought about by the protocols, see Leonard Toenz and Katja Krech, "Switzerland's Tax Cooperation Agreements with the UK and Germany" (2012) 67 *Tax Notes International* (July 2), 57–60.

Grinberg observes that Switzerland recognised that if it negotiates a small number of anonymous withholding agreements with key countries then this could “... potentially diffuse the pressure to offer uniform automatic information reporting to a broader group of countries.”<sup>83</sup> Consequently, Grinberg observes, Switzerland was insistent that the UK support the anonymous withholding model and not work against it when it was involved in future dealings with third parties. Switzerland remains committed to its approach notwithstanding Germany’s decision not to ratify its agreement with Switzerland. As Grinberg observes, “[t]he Swiss-U.K. agreement therefore helps establish the basis for a suboptimal equilibrium that militates against the emergence of a uniform multilateral automatic information exchange system.”<sup>84</sup>

In early July 2013, the Swiss Bankers Association is reported as stating that there is a much lower level of UK assets being held in Switzerland than previously assumed. In response HMRC Treasury indicated that there was no need from its perspective to revise the overall yield estimate.<sup>85</sup> On 16 July 2013, the FTA published the latest version of the instructions on the agreements on cooperation in the area of taxation with other states and the federal international withholding tax act. The instructions provide Swiss paying agents with an overview of the duties incumbent on them under the Cooperation Agreement, which are available on the FTA’s website.<sup>86</sup> The article now turns to focus on the US Government’s FATCA, with particular emphasis on the IGAs with the UK and Switzerland.

#### 4. THE FOREIGN ACCOUNT TAX COMPLIANCE ACT — A SWISS AND UNITED KINGDOM FOCUS

##### 4.1 An overview of FATCA

Further to the earlier introductory comments, Kogan summarises the objective of FATCA as follows:<sup>87</sup>

The FATCA framework is intended to *reduce the degree of foreign underreporting, underpayment and non-filing that gave rise to the offshore portion of the federal tax gap*. It aims to achieve this by requiring foreign financial conduits to establish tiered reporting and payment systems that trace for the IRS US source cross-border portfolio income remittances to individual offshore financial accounts directly or beneficially held by US persons. *Through improved reporting the IRS hopes to identify and recover specific revenue items that would otherwise be properly taxable and collectible if they had been properly disclosed.*

FATCA’s emphasis on transparency builds upon Treasury Department findings that *‘compliance is highest where parties other than the taxpayer*

<sup>83</sup> Grinberg, above n 6, at 17–18.

<sup>84</sup> Ibid, at 20.

<sup>85</sup> See further, Stephanie Soong Johnston, “UK has little to gain from deal with Switzerland” (2013) 71 *Tax Notes International* 225–227.

<sup>86</sup> See <http://www.estv.admin.ch/intsteuerrecht/themen/01317/01347/01352/index.html?lang=en> (accessed 25 July 2013).

<sup>87</sup> Lawrence A Kogan, “U.S. FATCA Information Reporting: A Pretext for Fishing With Like-Minded European and OECD Nations For Long Forsaken Tax Revenues at Exotic Offshore Locations (2012) *Lexis Nexis Emerging Issues* (December), 3–4 (footnotes removed, emphasis added).

*are required to file information reports and withhold taxes from payments made.'*

Kogan also observes that the OECD's TIEA framework and its information exchange provision under Article 26 of the OECD's *Model Tax Convention on Income and Capital* provide a partial basis for FATCA. An important difference, however, is that they have been unilaterally developed and implemented, rather than collectively as by the OECD (which focusses on providing incentives, not imposing penalties).<sup>88</sup> Kogan then reviews the general framework for FATCA, and highlights the decision by the EU to adopt Council Directive 2011/16/EU following the enactment of FATCA.<sup>89</sup> The Council Directive provides for the compulsory automatic exchange of available information, and prohibits refusals of requests solely on bank secrecy grounds. Kogan then observes:<sup>90</sup>

Despite the different approaches employed in the Council Directive and FATCA, the EU Commission has expressed its full support for FATCA's objective of "combat[ing] cross-border tax evasion by US persons who use foreign financial institutions (FFIs) to hide assets and avoid reporting income taxable in the U.S.", which the EU views as being consistent with the aim of the Savings Directive. The EU Commission arguably values FATCA because it "open[s] new perspectives for strengthening automatic information exchange between Member States and third countries." In fact, the Commission has expressed its intention "to continue working with the US towards a *more ambitious approach* on automatic exchange of information for tax purposes to be implemented in the longer term.

The remainder of this discussion draws upon an earlier work by Sawyer.<sup>91</sup> Unsurprisingly, the emerging literature on FATCA is US-focussed, highlighting the implications for non-US financial institutions; when originally enacted, there was no indication of the intergovernmental agreement (IGA) approach. Indeed, when first enacted, there were no US Treasury Regulations to assist such institutions in ascertaining their obligations and the implications should they not comply with FATCA.<sup>92</sup>

The US Treasury released Proposed Regulations in February 2012,<sup>93</sup> and accompanied these by a Joint Statement from France, Germany, Italy, Spain and the UK signalling

<sup>88</sup> Ibid, 5–7.

<sup>89</sup> Ibid, 7–12. See also, Council of the European Union, *Council Directive 2011/16/EU of 15 February 2011, on Administrative Cooperation in the Field of Taxation and Repealing Directive 77/799/EEC, OJ L 64/1* (3 November 2011) available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:064:0001:0012:EN:pdf> (accessed 6 March 2013).

<sup>90</sup> Ibid, 11 (footnotes removed, emphasis in original).

<sup>91</sup> See Sawyer, above n 14. Sawyer also provides a detailed analysis of the emerging literature on FATCA and thus there is no need to repeat this analysis in this paper.

<sup>92</sup> Guidance is available from the US IRS website (<http://www.irs.gov>), including details about the necessary forms to be filed (Form 8938).

<sup>93</sup> For a discussion see Roger S Wise and Mary Burke Baker, "Next phase of FATCA guidance arrives with proposed regulations and announcement of possible intergovernmental approach" (2012) 13(2) *Journal of Investment Compliance* 25–39. Final Treasury Regulations under FATCA were released in January 2013.

an intention to develop a compliance solution for FATCA.<sup>94</sup> The Joint Statement indicates that the policy objective of FATCA is to achieve reporting and not to collect the 30% withholding tax from foreign financial institutions.

Consequently, the US Government was open to an IGA approach to improve international tax compliance, and developed a Model IGA.<sup>95</sup> The main benefit of the IGA is its ability to address jurisdictional and legal problems associated with FATCA's extensive reach into foreign jurisdictions. The Model IGA seeks to keep compliance costs as low as possible for financial institutions, with the aim of over time working towards achieving common reporting and due diligence standards.<sup>96</sup> It also eliminates the obligation of each foreign financial institution to enter into a separate agreement with the IRS in order to be compliant with FATCA.<sup>97</sup> The Model IGA also sets out a possible framework for negotiating an IGA.<sup>98</sup> There are two versions of the Model IGA, namely Model 1 (reciprocal and nonreciprocal versions, which Denmark, Ireland, Mexico, Spain and the UK have signed) and the later Model 2 (which Switzerland has signed<sup>99</sup>). Other negotiating jurisdictions thus have a choice to base their negotiations for an IGA).<sup>100</sup> The discussion in this paper refers to an IGA or Model IGA. With time we will see which of the two Model IGAs is preferred, although the expectation is that Model 1 will be preferred by those where secrecy and transparency is less of a concern for their jurisdiction, with Model 2 for jurisdictions

<sup>94</sup> US Treasury Department, *Joint Statement from the United States, France, Germany, Italy, Spain and the United Kingdom regarding an Intergovernmental Approach to Improving International Tax Compliance and Implementing FATCA* (2012).

<sup>95</sup> Ibid, Article 4. On 26 July 2012 a Model IGA was released by the US Treasury. A second Model IGA was released later in 2012 as an alternative model for negotiating IGAs. For further details, see Benjamin Berk, Cynthia D Mann, Ehab Farah and Bridget M Weiss, "Treasury Releases Model Agreement for an Alternative FATCA Framework" (2012) 129(10) *Banking Law Journal* 923–928.

<sup>96</sup> Ibid, Article 6.

<sup>97</sup> See further, Arnold and Porter LLP, *Treasury releases model agreement for alternative FATCA framework* (2012) Advisory (July).

<sup>98</sup> US Government, *Model Intergovernmental Agreement to Improve Tax Compliance and to Implement FATCA* (2012). This Model Agreement is extensive, setting out a sizeable number of definitions, the timing and manner of exchange of information, the application of FATCA to financial institutions, collaboration on compliance and enforcement, a mutual commitment to continue to enhance the effectiveness of information exchange and transparency, and the process by which the IGA is ratified and how it may be terminated. There is an extensive appendix containing due diligence obligations for identifying and reporting on US reportable accounts and payments to certain non-participating financial institutions.

<sup>99</sup> Reciprocity is optional under Model 2; this model also requires the jurisdiction's FFIs to report directly to the IRS. Under a reciprocal IGA the US and its FATCA partner share information of each other's tax residents who holds financial accounts in the other's jurisdiction. Under the non-reciprocal version, only the US would receive information on its tax residents holding accounts in the other jurisdiction. For a discussion of the Swiss IGA, see Kristen A Parillo, "Switzerland and the US Sign FATCA Agreement" (2013) 69 *Tax Notes International* 715–717. Parillo observes that the Swiss IGA deviates from aspects of the Model 2 IGA including the absence of a commitment to work with other countries to develop a common model for automatic information exchange. Interestingly, the Swiss Federal Council has commenced negotiations with the US to examine a change to a Model 1 IGA, although it remains to be seen what will eventuate.

<sup>100</sup> Deloitte provide a succinct comparison of the Model 1 IGA, Model 2 IGA and the Final FATCA Regulations; see Deloitte (US), *Comparison of IGA Model Agreements to Final FATCA Regulations* (2013). Deloitte's analysis highlights some significant differences between the two versions of the Model IGA which indicates that subsequent actions based on these IGAs will differ to as degree (this is unable to be assessed at this time).



such as Switzerland and other traditional ‘tax haven’ jurisdictions. That said, Taylor, Shashy and Silverstein aptly observe:<sup>101</sup>

One critical element raised by both Model I and Model II is how foreign governments implement their side of the agreement. *Will the implementing rules in the local legislation be broadly similar across jurisdictions signing up to either model?* More importantly, *will compliance and enforcement of the rules be broadly similar?*

Under an IGA, the non-US jurisdiction (referred to as a ‘partner jurisdiction’) may enter into a reciprocal agreement with the IRS to adopt local laws under which FFIs will identify and report information about US accounts to the partner jurisdiction tax authority. The partner jurisdiction’s government will then pass that information on to the IRS. The result is that a FFI complying with local laws in a jurisdiction with a reciprocal-type agreement is compliant with the FATCA withholding and reporting requirements. As an alternative, the partner jurisdiction can enter into a non-reciprocal agreement by which they agree to both direct and enable FFIs to register with the IRS and report information regarding their US accounts directly to the IRS (this will not avoid the potential conflict of laws issue).<sup>102</sup> An FFI located in a jurisdiction with this type of agreement must still enter into an FFI agreement with the IRS and comply with the FATCA regulations, except to the extent modified by the IGA. Furthermore, according to de Clermont-Tonnerre and Ruchelman:<sup>103</sup>

*A global financial institution that does business in many jurisdictions could, along with its affiliates, be subject to the FATCA statutory provisions and also several different IGAs, which may have separate rules (unless possibly each IGA has a most favored nation clause similar to that in the U.K. IGA). This could cause massive compliance headaches and unnecessary expense for global financial institutions, unless such institutions attempt to apply a single — most stringent — procedure that would comply with all the different IGAs in place.* Anecdotal information indicates that, at least in theory, the Treasury Department has a ‘one size fits all’ approach for IGAs. This limits negotiation to the reciprocal and the non-reciprocal versions of the Model 1 IGA and to the Model 2 IGA.

On 9 May 2013, the US Treasury released five new Model IGAs, along with four accompanying annexes. The choice of model IGAs now provide for three versions of what was previously known as the Model 1 IGA: a reciprocal Model 1A Agreement where there is an existing TIEA or DTA; a nonreciprocal Model 1B Agreement where there is an existing TIEA or DTA; and a nonreciprocal Model 1B Agreement, where there is no TIEA or DTA. The Model 2 IGA now has two versions, namely a Model 2 Agreement where there is an existing TIEA or DTA and a Model 2 Agreement where

<sup>101</sup> John Clay Taylor, Hap Shashy and Sara Silverstein, “Third FATCA Compliance Model Announced” (2012) 129(9) *Banking Law Journal* 855–859, at 859 (emphasis added).

<sup>102</sup> See further, Jean-Francois de Clermont-Tonnerre and Stanley C Ruchelman, “A Layman’s Guide to FATCA Due Diligence and Reporting Obligations” (2013) 42(1) *Tax Management International Journal* 75–82, at 81–82. According to the authors, “[a] system is also under consideration for use by jurisdictions that have neither a Tax Information Exchange Agreement in place with the United States nor a comprehensive income tax treaty containing an exchange of information provision” at 81.

<sup>103</sup> *Ibid.*, at 82 (emphasis added).

there is no TIEA or DTA.<sup>104</sup> In part this new development indicates a move by the US to potentially incorporate the IGA negotiation process with its TIEA and DTA programmes, an issue that has been recently discussed in the literature. The updated Model IGAs are not substantially different to the earlier versions but reflect the existence of the Final Treasury Regulations. The new model Annex 2 should enable negotiations to speed up as it now accounts for the vast majority of entities. This has proved crucial in the lead up to July 1, 2014 with the negotiations with over 100 jurisdictions leading to 39 concluded agreements resulting in an IGA and 62 ‘in substance’ agreements.<sup>105</sup>

Prior to release of the Model IGA the US Treasury also issued joint statements with Switzerland and Japan concerning their approach to compliance, with a gradual move away from reporting to the IRS to that of each foreign financial institution reporting to their own tax authority.<sup>106</sup> From July 2012, the way forward is clearly an IGA. FATCA took effect from 1 July 2014 with a phased in application over the next three years. The article now turns its focus to the prior literature on FATCA.

Sawyer provides an overview of the emerging literature on FATCA, highlighting the concern over the constitutional rigor of the IGA approach.<sup>107</sup> Christians has seriously questioned the legal pedigree of IGAs, and their constitutional position.<sup>108</sup> She examines the options, concluding that the IGAs are not treaties, nor Congressional-Executive Agreements, nor Treaty-Based Agreements, and therefore must be Sole Executive Agreements. These are agreements made by the US President without Congressional authorisation. She states that this is “... a tenuous status in U.S. treaty-making that raises serious doubt about whether IGAs in fact bind the US as a matter of law.”<sup>109</sup> In contrast, Morse argues that the FATCA IGAs do bind the US Government, at least in the form of administrative guidance.<sup>110</sup> Morse reviews the case law concerning TIEAs and how the FATCA IGAs support the US’s treaty obligations. She argues that the courts should conclude that “... the IGAs bind the US government and require the government to offer the withholding tax relief set forth in the agreements.”<sup>111</sup> Indeed, Morse posits that FATCA IGAs may be brought into future tax treaty ratification rounds to “... cement the position that the IGAs are valid and enforceable congressional executive agreements or treaty interpretations.”<sup>112</sup>

<sup>104</sup> See <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx> (visited 14 May 2013). The US Treasury updated its Model IGAs on 12 July 2013, and then updated them once again on 19 August 2013. It also launched its FATCA website for online registration by FFIs, various forms and instructions, and made available online videos to assist in explaining the registration process for FFIs.

<sup>105</sup> US Department of the Treasury, *Resource Centre: FATCA Archive* (2014); at <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx> (accessed 8 July 2014). See further Randall Jackson, “ABA Meeting: Treasury looking to accelerate IGA creation” (2013) 70 *Tax Notes International* 752–753.

<sup>106</sup> See US Statement of 21 June 2012 with respect to each of Switzerland and Japan.

<sup>107</sup> See Sawyer, above n 14. Only a brief insight into the themes emerging from the literature is discussed in this paper.

<sup>108</sup> Allison Christians, “The Dubious Legal Pedigree of IGAs (and Why it Matters)” (2013) 69 *Tax Notes International* (February 11) 565–568.

<sup>109</sup> *Ibid.*, 567.

<sup>110</sup> Susan Morse, “Why FATCA Intergovernmental Agreements Bind the US Government” (2013) 70 *Tax Notes International* (April 15) 245–247.

<sup>111</sup> *Ibid.*, 247.

<sup>112</sup> *Ibid.*, 247.

From a European perspective, Eckl and Sambur observe,<sup>113</sup> prior to the February Joint Statement, that FFIs in Europe will not be able to avoid the impact of FATCA, even if they sought to implement a US-divestment strategy. Even if FFIs undertook such a strategy, the pass-through payments provisions would apply making such payments attributable to income derived from US sources. Consequently, FFIs need to develop strategies to minimise the impact of FATCA. Subsequently, as part of the Joint Statement, the IGA approach emerged. With the UK and Switzerland negotiating and signing an IGA under FATCA, it becomes important issue to contemplate when reviewing their positions under FATCA. The article now focuses on the UK and Swiss developments.

## 4.2 FATCA: The UK and Swiss developments

The UK was the first to sign an IGA under FATCA.<sup>114</sup> The UK-US agreement follows the Model 1 IGA (reciprocal version). Switzerland was the fifth country to negotiate an IGA under FATCA.<sup>115</sup> The most interesting feature (aside from Switzerland agreeing to information exchange with the US) is that a second model was created (Model 2) to enable Switzerland to provide certain information on a nonreciprocal basis to the US (although Switzerland may wish to request the US to provide it with information).

Even with the IGAs signed, uncertainty remained, although this has been reduced by the release of the final Treasury Regulations.<sup>116</sup> The Governments in the UK and Switzerland have released guidance material to assist FFIs in their jurisdictions to meet the obligations under the IGAs.

Key features of the UK IGA include a number of improvements over the Proposed Treasury Regulations for FATCA. For instance, legal barriers to compliance, such as those related to data protection, have been addressed. Importantly, withholding tax will not be imposed on income received by UK financial institutions, and neither will they be required to withhold tax on payments they make. There is a wider scope of institutions and products to be effectively exempt from the FATCA requirements. From a UK perspective, HMRC will receive additional information from the US IRS to enhance its compliance activities.

In welcoming the IGA, UK Chancellor of the Exchequer stated:<sup>117</sup>

<sup>113</sup> Petra Eckl and Jonathan Sambur, "The Impact of the US Foreign Account Tax Compliance Act (FATCA) on European Entities" (2012) 52(1) *European Taxation* 37-41.

<sup>114</sup> *Agreement between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland to Improve International Tax Compliance and to Implement FATCA* (14 September 2012). For an overview of the content of this IGA, see Edward Tanenbaum, "Here They Come: FATCA Intergovernmental Agreements" (2012) 41(11) *Tax Management International Journal* 623-625.

<sup>115</sup> *Agreement between the United States of America and Switzerland for Cooperation to Facilitate the Implementation of FATCA* (February 2013). The title of this agreement in itself is interesting is the emphasis on cooperation to facilitate FATCA, as compared to improving international tax compliance and implementing FATCA for the UK agreement.

<sup>116</sup> Final Treasury Regulations under FATCA were released on 17 January 2013; see Department of the Treasury Internal Revenue Service, *Withholding of Tax on Nonresident Aliens and Foreign Entities* (2013, Publication 515).

<sup>117</sup> HM Treasury, "G5 FATCA agreement strengthens UK ability to tackle tax evasion" (2012) *Press Release* (26 July); available at: [http://www.hm-treasury.gov.uk/press\\_67\\_12.htm](http://www.hm-treasury.gov.uk/press_67_12.htm) (visited 6 March 2013) (emphasis added).

We need to be as tough on tax evasion abroad as we are at home. The Model Agreement constitutes an important step in tackling international tax evasion. *We have achieved substantial changes to how FATCA will be implemented that will provide significant benefits to UK financial institutions while strengthening our ability to tackle the evasion of UK tax.* I look forward to the prompt conclusion of our bilateral negotiations and the signing of our agreement with the United States.

US Treasury assistant secretary, Mark Mazur is reported as stating:<sup>118</sup>

Today's announcement marks a significant step forward in our efforts to work collaboratively to combat offshore tax evasion. We are pleased that the United Kingdom, one of our closest allies, is the first jurisdiction to sign a bilateral agreement with us and we look forward to quickly concluding agreements based on this model with other jurisdictions.

BDO highlight the benefits of FATCA for the UK, and provide an updated timeline for the phased introduction of FATCA.<sup>119</sup> They also note that HMRC plans to issue an implementation consultation paper for UK firms in September 2013 to provide further practical guidance for complying with FATCA requirements. This will provide some (but not a lot of) time for firms to ensure they are fully compliant for 1 July 2014.

In analysing the UK Agreement, PricewaterhouseCoopers (PwC) observe, for example, that the definition of a banking or similar business is narrower under the IGA than under the Proposed FATCA Regulations.<sup>120</sup> They also examine the draft UK Regulations, and suggest there are areas in need of review, including treatment of Collective Investment Schemes and Trusts. The initial lack of detail over practical matters, such as the registration process, method for transmitting data, format for reporting data, compliance issues and such, has been largely resolved prior to the commencement of FATCA on 1 July 2014. Submissions on the UK's draft regulations closed at the end of February 2013. HMRC published in August 2013 the International Tax Compliance (United States of America) Regulations 2013 (ITC Regulations), which contain provisions for the implementation of the UK-US IGA.<sup>121</sup> These regulations are expected to come into force in mid-August 2013, and will have effect for financial accounts held at 31 December 2013. HMRC have also published updated guidance notes to accompany the ITC Regulations, which reflect the 6 month

<sup>118</sup> Marie Sapire and Kristen A Parillo, "First FATCA Intergovernmental Agreement Signed with UK" (2012) 67 *Tax Notes International* (September 24) 1171–1172, 1171.

<sup>119</sup> BDO, *FATCA: Model Intergovernmental Agreement* (September 2012); available from BDO's website at: [http://static.bdo.uk.com/assets/documents/2012/09/FATCA\\_-\\_Model\\_Intergovernmental\\_Agreement.pdf](http://static.bdo.uk.com/assets/documents/2012/09/FATCA_-_Model_Intergovernmental_Agreement.pdf) (accessed 6 March 2013).

<sup>120</sup> PricewaterhouseCoopers, "HM Treasury and HMRC release details outlining the implementation of FATCA in the UK" (2012) *Global IRW Newsbrief* (December 19), 1–6; available from PwC's website at: [http://download.pwc.com/ie/pubs/2012\\_global\\_irw\\_newsbrief\\_dec.pdf](http://download.pwc.com/ie/pubs/2012_global_irw_newsbrief_dec.pdf) (accessed 6 March 2013). See also PwC, "Some Observations About the UK FATCA Agreement" (2013) 69 *Tax Notes International* (January 7) 66–68. Advice has been provided by other leading international firms such as Deloitte, Ernst & Young and KPMG.

<sup>121</sup> House of Commons (UK), *The International Tax Compliance (United States of America) Regulations 2013*; available at: <http://www.legislation.gov.uk/uksi/2013/1962/contents/made> (accessed 15 August 2013).

deferral in respect of the commencement of FATCA on 1 July 2014, together with certain other changes made following informal consultations.<sup>122</sup>

US Treasury Officials finalised a universal electronic format for capturing FATCA data in March 2014.<sup>123</sup> Nevertheless, much work still remains to be done with respect to identifying foreign financial institutions on a multilateral basis, even though FATCA is now operative.<sup>124</sup>

Kogan observes that the UK Government has drafted a plan to replicate FATCA domestically for purposes of securing FATCA-consistent automatic TIEAs with its Crown Dependencies and Overseas Territories (for example, Guernsey, Jersey and the Isle of Man).<sup>125</sup> Kogan concludes:<sup>126</sup>

[I]f imitation is the sincerest form of flattery and what often goes around comes around, then the steady development and evolution of FATCA into an *internationally appealing global regime should warm the hearts of FATCA's US congressional authors and simultaneously send a chill down the spines of US and non-US taxpayers alike.*

An early view from UK firms reflects the sentiment of substantial complexity in their FATCA obligations and a hope that a 'best endeavours' approach to compliance would be acceptable.<sup>127</sup> Coder also comments that the UK thought it was getting a better deal in moving early to secure negotiations for an IGA (along with France, Germany, Italy and Spain), but was surprised when the US announced that Switzerland and Japan had negotiated their own variations to the Model IGA.<sup>128</sup> Coder then reports that Malcolm White, HMRC's FATCA policy lead commented:<sup>129</sup>

It's too burdensome, it's too complicated, and in many instances, it's extraterritorial and puts onerous conditions on businesses, in effect identifying every customer in the world" rather than just U.S. citizens, which is the goal of FATCA, he said. If only IRS officials were as blunt. ... There is no world in the future that doesn't have FATCA in it.

<sup>122</sup> HMRC, *Implementation of The International Tax Compliance (United States of America) Regulations 2013: Guidance Notes* (2013); available at: <http://www.hmrc.gov.uk/fatca/index.htm> (accessed 15 August 2013).

<sup>123</sup> See IRS, *International Data Exchange* (2014); <http://www.irs.gov/Businesses/Corporations/International-Data-Exchange> (accessed 8 July 2014).

<sup>124</sup> Jamie Arora, "FATCA Progress Expected to Accelerate IGA Process" (2013) 69 *Tax Notes International* (February 18) 636–637.

<sup>125</sup> Kogan, above n 87, 12. In April 2013 Jersey announced that it had finalised a 'FATCA' style agreement with the UK Government; see KPMG, "Jersey agrees to the UK tax package". An agreement for automatic EOI was signed between Guernsey and the UK on 22 October 2013. On the same day the UK and Jersey also signed an automatic EOI agreement. Furthermore, on 5 November 2013, the Cayman Islands and the United Kingdom signed an IGA which closely follows the FATCA IGA currently initialled between the Cayman Islands and the US. See further <http://www.hmrc.gov.uk/fatca/> (accessed 8 July 2014).

<sup>126</sup> Kogan, above n 87, 12 (emphasis added).

<sup>127</sup> Jeremiah Coder, "UK Investment Funds Struggle to contain FATCA Fallout" (2012) 67 *Tax Notes International* (July 9) 132–134.

<sup>128</sup> Jeremiah Coder, "UK Hoping US will make FATCA Easier to Swallow" (2012) 67 *Tax Notes International* (July 9) 95–97.

<sup>129</sup> *Ibid.*, 95.

White comments that the UK is not planning to introduce its own version of FATCA, and that he sees the IGA as putting the UK in a better position than under the Proposed Treasury Regulations.<sup>130</sup>

Coder suggests that while the IGA approach was intended to limit the scope of reporting obligations for FFIs using a risk-based approach, the downstream burdens of FATCA reporting may reduce these benefits.<sup>131</sup> Using the UK IGA as the basis for the analysis, HMRC's policy lead for FATCA, Malcolm White, observes that the global intermediary identification number (GIIN) is a good result. The GIIN will cast a wide net as outlined in the Final Regulations under FATCA. According to White, the IGA sets a new standard of automatic information exchange that will flow two ways. This in turn presents opportunities for new unilateral and bilateral agreements. White also suggests that countries will create their own versions of FATCA to enable them to benefit from enhanced information exchange.<sup>132</sup> As more IGAs are negotiated, this should reduce the problems associated with pass-through payment withholding. Being the first country to negotiate an IGA, the UK is somewhat of a pioneer in ironing out issues as well as setting the agenda for other countries. Unsurprisingly, many such countries have consulted with the UK as part of their decision to enter into negotiations with the US for an IGA. HMRC also expects noncompliance with the IGA to be due to minor administrative failures rather than significant noncompliance leading to a sanction under the IGA.<sup>133</sup>

With the UK being the first to sign an IGA, it is expected that there will be some developments that lead to variations in subsequent IGAs and the need for the UK to update its IGA accordingly. In this context, Sheppard comments:<sup>134</sup>

Treasury wants the IGAs to be ambulatory agreements, so that changes to FATCA regulations can be accommodated without formal amendments to the agreements. No country wants ambulatory IGAs more than the U.K., the first country to sign.

Turning the focus now to the Swiss IGA, Harvey, who was involved in developing FATCA, provides some early insights into the Swiss response to FATCA.<sup>135</sup> Harvey emphasises that while Switzerland has the sovereign right to adopt favourable tax and bank secrecy rules, the US also has the sovereign right to protect its tax base by implementing FATCA. Furthermore, if a Swiss financial institution does not want to be part of that regime, it can either avoid the US financial system or incur the 30% withholding tax.<sup>136</sup> Harvey then suggests that the conservative estimate of FATCA raising \$US 8.7 billion could be closer to \$US 30–50 billion, which would suggest the benefits (from a US perspective at least) would substantially outweigh the costs.<sup>137</sup>

<sup>130</sup> Ibid, 97.

<sup>131</sup> Jeremiah Coder, "FATCA's Practical Efforts Limit Good Intentions" (2013) 69 *Tax Notes International* 718–719.

<sup>132</sup> Ibid, 718.

<sup>133</sup> Ibid, 719.

<sup>134</sup> Lee A Sheppard, "What Bankers Want From FATCA" (2013) 69 *Tax Notes International* 991–992, at 992. The US and the UK have signed a revised Annex II to their IGA, recognising changes to the Model IGAs. The new Annex II comes with a number of changes; see further Kristen A Parillo, "US and UK Sign Revised Annex II to FATCA Agreement" (2013) 71 *Tax Notes International* 47–48.

<sup>135</sup> J Richard Harvey Jr, "FATCA — A Report from the Front Lines" (2012) *Tax Notes* (August 6) 713–716. For a broad overview of the Swiss IGA, see Taylor et al, above n 101.

<sup>136</sup> Ibid, 713–714.

<sup>137</sup> Ibid 714.

Harvey reminded his audience that FATCA builds on the US's Qualified Intermediary regime, and further suggests that in terms of Swiss FI's business models, they should focus on the end game, namely some form of multilateral FATCA regime.<sup>138</sup> Swiss financial institutions appeared to be focussed on closing US customer's accounts, refusing to open new accounts, and demanding outstanding loan balances. Harvey ponders whether this may be designed to make US citizens' lives more difficult and encourage them to advocate for a repeal of FATCA.<sup>139</sup> Harvey concludes with his positive assessment of the moves by the US to address the use of offshore accounts to evade US tax but acknowledges there remains more to be done. While Harvey advocates for a multilateral approach to FATCA,<sup>140</sup> efforts to date through the IGA Model suggest a limited bilateral approach towards cooperation with no sign of a multilateral approach on the horizon.

Furthermore, the State Secretariat for International Financial Matters (SIF) in early 2013 made it clear that Switzerland rejects the automatic exchange of information, a key issue when it negotiated its IGA.<sup>141</sup> On 29 August 2012, the Swiss Federal Council issued a mandate for negotiations with the US on a framework to simplify the implementation of FATCA based on Model 2. An IGA was initialled by the US and Switzerland on 3 December 2012, and finalised on 14 February 2013. It was enacted into Swiss law with effect from 30 June 2014. However, in October 2013, Switzerland signed the OECD's Multilateral Convention,<sup>142</sup> suggesting that it is prepared to embrace the OECD's global standard, namely automatic exchange of information.

The Swiss IGA, based on the Model 2 IGA (but with some variations), provides that Swiss financial institutions deliver information on US accounts directly to the IRS rather than via government bodies (this works in the same way as FATCA itself). Furthermore, financial institutions are not obliged to report the names of recalcitrant<sup>143</sup> US clients, or make a tax deduction for such clients or terminate the client relationship with them. The US can request administrative assistance concerning recalcitrant clients by means of group requests. Information will not be transferred automatically in the absence of consent, but exchanged on the basis of the administrative assistance clause in the DTA. Swiss financial institutions are considered to benefit from simplification measures for the identification of their clients. Importantly, many financial institutions that operate primarily on a local or regional basis are deemed compliant with FATCA. The IGA confirms that the insurance (property insurers) and pension sector (social security funds, pension funds) are excluded from FATCA. Also, independent asset managers are relieved of the obligation to conclude a FATCA contract. With the IGA, the US will not implement the 30 per cent withholding tax. Importantly, the US Treasury Final Regulations on FATCA are applicable to the

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<sup>138</sup> Ibid 714–715. The Governments of the UK, France, Germany, Italy and Spain advised the European Commission on April 9, 2013, that they had agreed to work on a pilot multilateral exchange facility similar to the Model IGA to implement FATCA; see KPMG, "United Kingdom — Update on pilot multilateral exchange of information".

<sup>139</sup> Ibid 715–716.

<sup>140</sup> Ibid 716.

<sup>141</sup> State Secretariat for International Financial Matters, *Implementation FATCA* (14 February 2013); available at: <http://www.sif.admin.ch/themen/00502/00807/index.html?lang=en> (accessed 6 March 2013).

<sup>142</sup> OECD, above n 8.

<sup>143</sup> A client who does not consent to the financial institution transmitting data to the IRS is considered to be recalcitrant.

extent that the Swiss IGA and its annexures do not expressly make provision for derogations from the rules.

Overall, the SIF concludes that this bilateral agreement is in the interests of Switzerland, on the basis that without it Swiss financial institutions would have to manage without reductions in the administrative burden for FATCA implementation. Such a situation would result in a competitive disadvantage relative to financial institutions from countries that have entered into an agreement with the US. The IGA was submitted to the Swiss Parliament for approval and would be subject to an optional referendum. This agreement was approved by the Swiss Parliament<sup>144</sup> and subsequently made effective from 30 June 2014, just prior to FATCA taking effect on 1 July 2014.

This Model 2 IGA is a two-stage, indirect mode of automatic information exchange that effectively works like a direct mode of automatic information exchange. Thus, where there is obstruction from the Swiss accountholder (the recalcitrant client), the IRS will need to file an information request with the foreign tax authority. This means it will take longer for the IRS to have the information at its disposal since it needs a group request on the grounds of the aggregate information. Thus automatic exchange for the purpose of the Swiss IGA applies only with the US, it has the two stages (as noted earlier), and works in one direction towards the US. Interestingly, the Swiss IGA does not contain a commitment, such as that set out in Article 5 of Model 2 (and Article 6 of Model 1), to work with other countries to develop a common model for automatic information exchange.

Byrnes and Munro comment that the group request provision in the Swiss IGA is likely to be tested in the Swiss courts when the first account data for recalcitrant accountholders is the subject of a group request.<sup>145</sup> In relation to the TAAA, they observe that the definition of ‘group’ is narrower than under the FATCA regulations, thereby suggesting that with aggregate requests under FATCA this is unlikely to permit the exchange of information. Nevertheless, the authors do not expect the Swiss courts to decide such a case in favour of the taxpayers. Swiss Parliament approval (which has been received) will effectively be legally binding on the Swiss Courts.

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<sup>144</sup> Thierry Boitelle, “Game, Set, Match USA: The Swiss-US Agreement that Doesn’t Exist” (2013) 70 *Tax Notes International* 1203–1204. The Swiss Council of States (upper house) voted in favour of the US-Swiss IGA on June 20, 2013; see further Kristen A Parillo, “Upper House Approves FATCA Agreement” (2013) 71 *Tax Notes International* 45. The US and Switzerland signed a memorandum of understanding on June 7, 2013 to their FATCA IGA to clarify several provisions; see further Kristen A Parillo, “US and Switzerland Sign MOU on FATCA Agreement” (2013) 70 *Tax Notes International* 1180. Separately on June 19, 2013, the lower house of the Swiss parliament defied the upper house and voted against ratifying an information exchange agreement with the US that would have required Swiss banks to divulge some client information in return for immunity from prosecution; see further Thierry Boitelle, “Swiss Vote Dooms Bank Agreement with US” (2013) 70 *Tax Notes International* 1249. On 27 September 2013, the Swiss parliament approved an amended implementation act regarding the Switzerland — United States FATCA Agreement (2013) of 14 February 2013, largely designed to enable Swiss financial institutions to benefit from the US’s decision to delay the implementation of FATCA to 1 July 2014. This was given effect by way of an exchange of notes.

<sup>145</sup> William Byrnes and Robert Munro, “FATCA and Switzerland: Modell II”, in *Guide to FATCA Compliance* (May 2013), Chapter 19. See also the comments by Gregory C Walsh, Mélanie Crea-Cina, Luubomir Georgiev and Marnin J Michaels, “The Latest Model” (2013) *Step Journal* (May).



In announcing the Swiss-US IGA, Geneva-based lawyer Thierry Boitelle is reported as stating:<sup>146</sup>

Today marks a huge step for Switzerland in becoming a compliant jurisdiction for US persons, where bank secrecy remains when it comes to privacy but where privacy can no longer be a pretext for tax evasion. ... *I think this is a great step forward in Swiss-US bilateral relations, and I am happy that we have achieved this result in a relatively short time frame.* With this agreement entering into force — hopefully soon — the US and Switzerland can devote their time and energy to other bilateral tax issues, in a much more positive context.

Temple-West comments that the Swiss Bankers Association welcomed the FATCA IGA but remains critical of the compliance and administrative burdens of the associated US law. He also notes that the Swiss IGA may serve as the model for Luxembourg and Austria as they seek to negotiate IGAs.<sup>147</sup>

Thus, having analysed the UK and Swiss IGAs under FATCA, the paper now draws out some emerging themes and issues as a result of comparing these two IGAs. Most recently, on 7 June 2013, Switzerland and the US signed a memorandum of understanding on technical and administrative interpretations of their IGA concerning FATCA.<sup>148</sup> On June 7, 2013, the US and Switzerland signed a Memorandum of Understanding with regard to their IGA.<sup>149</sup>

The apparent ‘acceptance of the inevitable’ is not held by all in Switzerland. On October 7, 2013, a coalition of Swiss political groups announced plans to launch a referendum against the Swiss law implementing its IGA under FATCA. Under the political system, if this group can gain sufficient signatories, the issue will be put to a national vote.<sup>150</sup> Nevertheless, FATCA’s application, including disclosure obligations, took effect from 30 June 2014 for Switzerland. Furthermore, it would appear Switzerland is seeking to ‘speed up the thaw’ with respect to exchange of information. The Swiss Federal Council announced that it intends to switch its IGA under FATCA from the current Model 2 format to the more expansive Model 1 format (potentially with reciprocal exchange of information). Negotiations in this regard commenced in May 2014.<sup>151</sup>

## 5. EMERGING THEMES AND ISSUES

The preceding discussion on moves by the UK to conclude a cooperation agreement with Switzerland outside of an EU-wide agreement with Switzerland, and each of Switzerland and UK negotiating an IGA with the US under FATCA, are evidence of a

<sup>146</sup> Kristen A Parillo, “Switzerland and US Sign FATCA Agreement” (2013) 69 *Tax Notes International* (February 25) 715–717, 715 (emphasis added).

<sup>147</sup> Patrick Temple-West, “Update 2: Switzerland, US sign pact on fighting tax evasion” (2013) *Reuters* (February 14); at <http://www.reuters.com> (accessed 20 March 2013).

<sup>148</sup> See [http://www.swissinfo.ch/eng/business/Swiss\\_and\\_US\\_agree\\_on\\_FATCA\\_interpretation.html?cid=36086564](http://www.swissinfo.ch/eng/business/Swiss_and_US_agree_on_FATCA_interpretation.html?cid=36086564) (accessed 14 June 2013).

<sup>149</sup> See Kristen A Parillo, “US and Switzerland Sign MOU on FACTA Agreement” (2013) 70 *Tax Notes International* 1180.

<sup>150</sup> Stephanie Soong Johnston, “Swiss Coalition Seeks FATCA Referendum” (2013) 72 *Tax Notes International* 104–105.

<sup>151</sup> Ulrika Lomas, “Switzerland Enacts Law to Support FATCA” (2014) *Tax-News.com* (accessed 8 July 2014).

new era of closer cooperation between these three nations. Their relationships can be illustrated as follows in Figure 2:

**Figure 2: UK and Swiss international tax relationships**

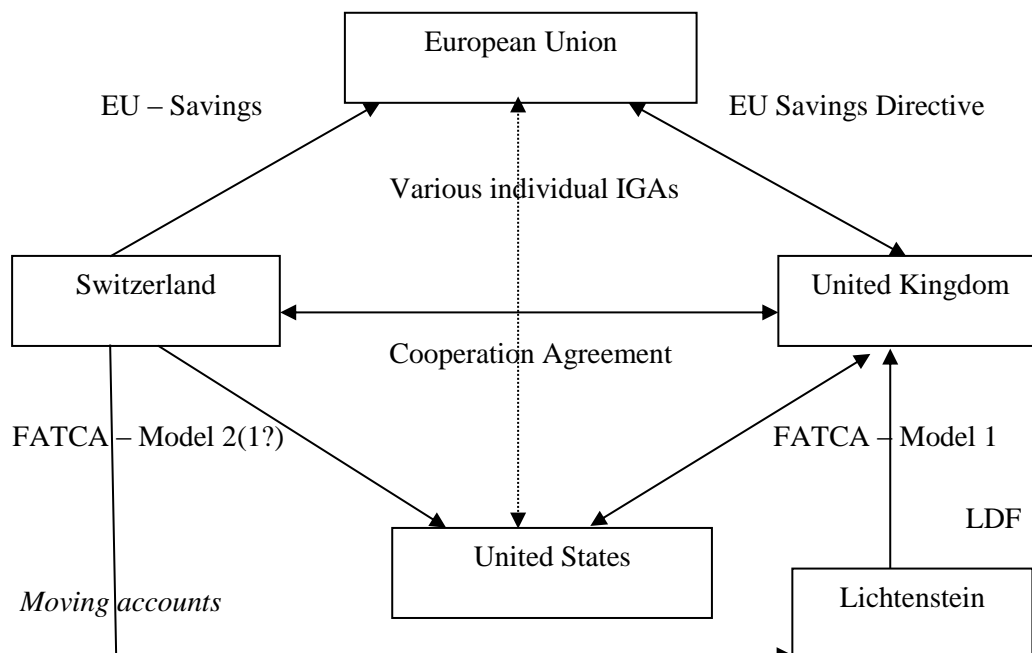


Figure 2 illustrates the relative complexity of the agreements between each of Switzerland, United Kingdom, United States and the European Union in relation to tax cooperation that have been analysed in this paper. The discussion does not consider the various DTAs between the three countries and members of the EU, nor the fact that the US, UK and Switzerland are signatories to the OECD's Multilateral Convention (although Switzerland is yet to ratify).<sup>152</sup> The arrows are indicative of the flow of information, illustrating clearly the Swiss refusal to enter into automatic exchange of information agreements, albeit reluctantly being will to cooperate in tax matters. Figure 2 does not reveal the extent to which discussions and subsequent agreements reached between the UK and its dependencies (such as Guernsey, Jersey and the Isle of Man) for FATCA-type IGAs and efforts by the UK to align more closely their relationship with these jurisdictions.

Also not illustrated above in Figure 2 is the EU's desire to create an EU-Switzerland Cooperation Agreement rather than have separate agreements, such as the UK-

<sup>152</sup> Recently, in June 2013 the G20 has endorsed the Multilateral Convention as the basis for which the OECD's desired standard of automatic exchange of information should be based; see OECD, *A Step Change in tax Transparency: OECD Report for the G8 Summit* (OECD, 2013). The G8 comprises Canada, France, Germany, Italy, Japan, Russia, United Kingdom and United States. Switzerland signed the Multilateral Convention on 15 October 2013, becoming the 58<sup>th</sup> country to do so; see further OECD, *Switzerland signs Multilateral Convention on Mutual Administrative Assistance in Tax Matters*, (2013) Media Release; available at: <http://www.oecd.org/tax/switzerland-signs-multilateral-convention-on-mutual-administrative-assistance-in-tax-matters.htm> (accessed 16 October 2013).

Switzerland and Austria-Switzerland agreements. Figure 1 earlier in the paper illustrates how the UK-Swiss Cooperation Agreement has two parts to it, namely the regularising of the past (up to 31 May 2013) and the position going forward. Related to this Cooperation Agreement is the option to use Lichtenstein's disclosure facility until early April 2016.

The labyrinth of relationships above suggests both a world that is getting closer, potentially more cooperative, but at the same time, immensely complex for taxpayers, their advisors, and various financial institutions/agents, to determine the implications for those holding accounts in Switzerland under the new closer relationship with the UK and the US. Concurrently the LDF option needs to be compared with the UK-Swiss Cooperation Agreement.

Arguably there is a common origin to these developments, namely the EU's Savings Directive for EU members, necessitating changes to domestic legislation in EU member countries, and the OECD's Multilateral Convention. Both agreements have been influential on the development of FATCA, with the EU Savings Directive particularly influential on changes to the UK-Swiss Cooperation Agreement. However, perhaps the greatest influence was the Swiss decision in March 2009 to change its stance in terms of cooperating with other countries on tax administration through introducing the information exchange concept into its DTAs. The recent enactment of the TAAA signifies a new willingness by Switzerland to formally legislate for enhanced tax cooperation, signalling the 'thaw' in secrecy and a move towards enhanced cooperation is well and truly underway.

Perhaps this change in stance was influenced by developments with the UBS and the US, perhaps it was a recognition that Switzerland needed to adapt if it were to survive as a major financial centre. It is clear that Switzerland needed to act with regard to FATCA otherwise its financial institutions would be severely hampered in raising and attracting capital investments.

From the other side, the UK has managed to be a leader in terms of signing the first IGA with the US under FATCA, expecting to receive benefits that other jurisdictions would not (subsequent developments have largely negated its 'first cab off the rank' approach). It also ratified the first Cooperation Agreement with Switzerland to secure outstanding taxes on UK residents (domiciled and non-domiciled in the UK); Austria has followed but Germany failed to ratify its agreement. A similar agreement may be negotiated by Switzerland with France. The UK has been particularly successful in negotiating an upfront payment of up to £1.3 billion by 31 May 2013 and a number of named taxpayer information requests.

To expect the path ahead to be a smooth one would be naïve. FATCA continues to be a moving target, although with the Final Treasury Regulations available, the focus is now on the practical implementation of the IGAs (including the sizeable number of negotiations leading to in substance agreements). As at the time of writing, July 1, 2014, has just passed and FATCA has 'commenced'. In terms of the various disclosure-type cooperation agreements, these are in their early days and estimates of revenue for the UK (under both the Swiss agreement and LDF) have proven to be too optimistic. However, the likelihood of a significant windfall for the UK may be evaporating as future payments on behalf of Swiss banks are not expected to be at the

levels suggested by the UK Treasury. Indeed as Johnson has suggested,<sup>153</sup> given the limitation of these new rules to focus on account holders who are individuals, the disclosure requirements do not extend to trusts and companies. Many Swiss direct account holders are expected to be entities with the agreements unable to be used to trace back to beneficial owners who are individuals.

As with most tax changes, once those affected work through the issues, they will look to either find new ways to stay outside of the new disclosure regime (such as by switching to untaxed substitutes), or if this proves to be too difficult, will evaluate their options to determine which is the least fiscally expensive and the least risky from the perspective of possible penalties. With respect to the UK, the LDF is recommended to be safer than the UK-Swiss Cooperation Agreement, although this will require UK residents to transfer their accounts to Lichtenstein and make the disclosure by early April 2016. Others will have come forward and made their disclosure before 31 May 2013. Some will choose to do nothing and have the withholding tax applied. Still others will look to change the way they hold their accounts and move these into a trust or company structure. Furthermore, it would appear that Swiss deposit holders are substituting their investments for untaxed alternatives rather than actively complying.<sup>154</sup> From a FATCA perspective, much of the decision-making is taken away from the account holders; the Swiss authorities will be responding to requests made under the IGA or alternatively FATCA will apply with the 30% withholding tax imposed.

Collectively these initiatives show a closer relationship between the UK and Europe, and particularly the UK and Switzerland, the jurisdiction that has proved to be an obstacle in the past to provide information such that UK tax authorities can impose tax on income held in Swiss accounts. How effective this will be remains to be seen, particularly in terms of how account holders react, including whether use of the LDF is seen as a preferable approach. It also shows a closer relationship between the US, UK and Switzerland, with the UK and Switzerland signing the first and fifth FATCA IGAs, respectively. Even here Switzerland has had limited success in refusing to recognise automatic informatics exchange but permitted a limited form of group requests based on a second form of Model IGA. However, Switzerland's decision to sign the Multilateral Convention as well as to commence negotiations for a Model 1 IGA, suggest it is prepared to work with enhanced information exchange, including potentially the OECD's desired global standard of automatic exchange of information.

## 6. CONCLUDING OBSERVATIONS AND FUTURE RESEARCH

The preceding discussion may appear to illustrate a web of complex arrangements to enhance the level of cooperation between three major financial centres (Switzerland, UK and US), with some influence asserted by the EU. It is also premised on agreements, which one expects will be examined closely in terms of particular wording, their scope, and whether an approach based on the underlying purpose and spirit should be taken, or one of ordinary interpretation of the words. Much fanfare has emerged over these momentous changes following the GFC, especially that of Switzerland in moving away from its strict protection of bank secrecy, to a limited form of providing information in accordance with various agreements. The change I

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<sup>153</sup> See Johnson, above n 76 and n 78.

<sup>154</sup> See Johannesen, above n 61.

would argue is largely due to self-protection and an appreciation that Switzerland needs to operate within the new emerging global tax cooperation environment.

However, this paper has a number of limitations. The most important of these is that the comments reflect those of an ‘outsider’, rather than someone closely involved with the various cooperation agreements, and the subsequent ratification decisions, and the FATCA IGA negotiations. That said it is an advantage, in that being an outsider, one is more free to offer a critical realist’s perspective without the limitations of secrecy and restrictions on publicly commenting on matters of national importance associated with one’s occupation, particularly as a government official.

A more significant limitation is that these are emerging developments and their full impact is yet to be felt. Indeed FATCA now applies from 1 July 2014, and the UK-Swiss Cooperation Agreement has moved on from the ‘regularising of the past phase’ as we are now past 31 May 2013. Consequently as data on their use by the revenue authorities is made available it is reviewable. A further limitation is that without reviewing the effects on smaller jurisdictions that may be unable to enter into some form of international agreement (or treaty); these observations may not be more widely generalizable.<sup>155</sup>

In terms of future research, there is clearly considerable scope to review whether these various agreements have been effective in achieving their objective once they have been operative for some time. Thus in relation to the US-Swiss Cooperation Agreement, it will be of interest to assess how much revenue the UK secures from both the regularising of the past and the future approaches to disclosure and taxing UK residents with Swiss accounts. Early signs are that it will be significantly less than originally expected. Likewise, it will be revealing as to whether the LDF continues to prove to be lucrative for the UK, and whether the Swiss courts receive any challenges to the operation of the agreement. Again, it is anticipated now that the revenue raised will be less than half that originally expected.

Similarly, now that FATCA is operative, research into behavioural changes, revenue collection and any potential challenges in the Swiss Courts will offer plenty for future researchers to examine. More broadly, the overall development of FATCA (such as how many other jurisdictions will conclude an IGA on the Model 2 basis similar to Switzerland, or indeed whether Switzerland will actually move to a Model 1 IGA), and whether the EU takes action to conclude an EU-wide agreement with Switzerland, remain appealing areas for further research.

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<sup>155</sup> See Rosenzweig, above n 32.

# Reforming the dark art of GST forecasting

Richard Eccleston, Institute for the Study of Social Change, University of Tasmania

Timothy Woolley, Institute for the Study of Social Change, University of Tasmania\*

## ***Abstract***

A decade after its introduction the Goods and Services Tax (GST) and its role in funding the States and Territories in the Australian federation is once again on centre stage of the national political debate. As a precursor to the forthcoming review of the Australian federation, this paper focuses on a technical yet significant aspect of intergovernmental financial reform, namely enhancing the transparency and accuracy of the methods State Governments use to forecast GST revenues. Without a consistent and credible national framework for forecasting GST revenues, State forecasts will continue to deviate significantly from projections published by the Commonwealth. We argue that while the States are justified in abandoning Commonwealth projections, the GST Distribution Review's recommendations to address the problem do not go far enough. There is need to develop a transparent national approach to forecasting GST distributions administered by the Commonwealth Grants Commission as part of the broader debate about reforming the governance of the Australian Federation. Such an approach would yield credible forecasts and is less dependent on State cooperation and information sharing than the model recommended by the GST Distribution Review.

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## 1. INTRODUCTION

Australia is on the verge of a national debate concerning the nature and financial foundations of its federation. As the Commonwealth's Commission of Audit makes clear, a central plank of this agenda will be establishing a simpler and more efficient model of intergovernmental financial relations which will promote State sovereignty and financial accountability within the federation (NCA 2014, 142–150). It is inevitable that part of the broader debate will consider whether the Goods and Services Tax (GST) is likely to provide the States and Territories with sufficient revenue to meet their future expenditure needs, and whether the current GST 'pool' is being distributed to the States in an equitable and sustainable manner. One of the persistent criticisms concerning the process used to distribute the GST is the lack of transparency and predictability in the methods State Governments use to forecast future GST revenues. As there is no nationally accepted framework for forecasting GST relativities, State governments have been forced to develop their own forecasting methodologies which deviate substantially from projections published by the Commonwealth.

This debate about reforming GST forecasting comes at a time of intensifying intergovernmental conflict surrounding fiscal federalism in Australia. This conflict, and the need to adopt new forecasting methodologies, has arisen in the wake of lower rates of GST revenue growth in the aftermath of the 'Financial Crisis' and amid disputes concerning the distribution of resource revenues in the Australian federation (Daley, Walsh and Keen 2013; Swan 2013). Within this political and financial context there is a clear case to develop and adopt a consistent, transparent national approach for forecasting GST distributions.

Debate concerning the reform of intergovernmental financial relations in Australia came to the fore in the *GST Distribution Review* (2012). *The Review* made a number of key findings including the need to develop a new mining revenue assessment regime; that the Commonwealth should underwrite the GST pool; and a number of other procedural reforms. One of the procedural reforms of *The Review* was that the current State and Commonwealth relativities forecasting and projections regime is misleading and in need of reform. We agree with this assessment, but argue that *The Review's* belief that increased intergovernmental cooperation between the States will result in more credible relativity forecasts does not reflect the reality of political relations in the Australian federation and the decline in intergovernmental cooperation in relation to financial issues.

The paper begins with an overview of Australia's Horizontal Fiscal Equalisation (HFE) regime and its implications for determining and forecasting GST distributions to the States. Having provided this historical context we present a critique of the current GST forecasting regime in the context of increasing revenue volatility in the aftermath of the Financial Crisis and Resources Boom. Section 3 presents original data assessing the extent of variation between Commonwealth projections of GST distributions to the States relative to their own forecasts. While the data does not support the hypothesis that States systematically over-estimate future GST revenues, significant State-specific variations (over 17% in the case of Western Australia and Tasmania) between Commonwealth GST projections and forecasts prepared by State Treasuries over the forward estimates highlights the need for developing a consistent national approach to GST forecasting.

The paper concludes by considering options for reforming the GST forecasting regime. After considering the recommendations of the 2012 *GST Distribution Review* we argue that a consistent national approach to GST distribution forecasting should be

administered by the Commonwealth Grants Commission (CGC) in order to enhance the accuracy and credibility of State budgeting without compromising their financial independence from the Commonwealth. Such an approach would enhance the political legitimacy of State budget processes, reduce the incentives for States to over or underestimate their relativity, and help restore credibility to State public finances. The States in turn would have greater accountability as they would have to attempt to budget within the confines of CGC forecasts.

## 2. HORIZONTAL FISCAL EQUALISATION AND ITS IMPLICATION FOR GST DISTRIBUTION

The introduction of the GST in July 2000 by the Howard Coalition Government had the aim of putting State finances on a secure footing. At that time Treasurer Peter Costello claimed “[t]he GST will provide the States and Territories with a secure source of revenue that grows as the economy grows to secure funding for essential services, such as schools, hospitals and roads” (as quoted in Hamill 2006, 126). Prior to the onset of the Financial Crisis, the GST largely lived up to the Howard Government’s claims, with revenues distributed to the States rising by an average of 8.9 per cent per annum in nominal terms between 2000–07 (GST Distribution Review 2012, 154; Eccleston 2008, 39). This increase in general purpose payments to the States was widely lauded although more recently Australia’s unique approach to distributing these grants through a system of comprehensive horizontal fiscal equalisation (HFE) has been subject to criticism (Williams 2012; Warren 2012a; Garnaut 2013).

From the early 20<sup>th</sup> century there has been broad political support for equalisation in the Australian federation (see Mathews and Grewal 1997; CGC 2008). This goal of equalisation was formally adopted in 1933 with the creation of the CGC as an independent body designed to ensure adequate funding for the States (CGC 2008, 1, 25–28). Until the 1970s Australia’s equalisation regime was limited to transfers to poorer claimant States, but the Fraser Government’s ‘New Federalism’ gave rise to a comprehensive approach where the revenue capacities and costs associated with service provision of all States (and later Territories) were assessed and used to allocate Commonwealth transfers (CGC 2008, 28; 32). This gradual shift from ‘partial equalisation’ under which the CGC recommended Commonwealth assistance to claimant States, to a system of ‘comprehensive horizontal equalisation’ whereby the capacity of all States were assessed and compared to a national average has had numerous consequences (Williams 2012, 148–150). Specifically, under the current regime the overall amount of GST raised in one State or Territory is pooled rather than being retained in the jurisdiction in which it was raised. Each State’s share of the GST pool is determined by the CGC, an independent statutory body which is at arms-length from the Commonwealth.

The CGC achieves HFE through providing a recommendation to the Commonwealth for each State’s funding relativity, which is used to determine their share of the GST pool. The CGC (2013, 144) describes a State’s funding relativity as “[a] per capita weight assessed by the Commission for use by Treasury in calculating the share of the GST revenue a State requires to achieve horizontal fiscal equalisation”. The per capita benchmark is presented in projections and forecasts as outlined in Table 1 (below). The relativities themselves are determined by a formula designed to ensure each State has the fiscal capacity to deliver services of a similar standard across the federation after taking account of State-specific cost and revenue raising factors (CGC 2013, 71–73). Variations in a State’s relativity have a major impact on a State’s budget position, especially when a jurisdiction depends on GST revenues for a significant portion of their funding. For example, the decline in GST growth rates have been hard felt in small non-resource jurisdictions like the Northern Territory and



Tasmania where their GST allocation represented 58.9 per cent and 35.5 per cent respectively of total revenue for 2012–2013 (GST Distribution Review 2012, 77).

**Table 1. Commonwealth Projected Relativities 2012–16**

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Average (per capita)
2012-13	0.95312	0.92106	0.98477	0.55105	1.28472	1.58088	1.19757	5.52818	1.0000
2013-14	0.96576	0.90398	1.05624	0.44581	1.26167	1.61454	1.22083	5.31414	1.0000
2014-15	0.97500	0.88282	1.07876	0.37627	1.28803	1.63485	1.23600	5.66061	1.0000
2015-16	0.96513	0.88240	1.09328	0.36355	1.29491	1.71346	1.23444	5.70038	1.0000
2016-17	0.94732	0.87560	1.13192	0.34988	1.33452	1.68279	1.21322	5.67391	1.0000
2017-18	0.95023	0.88592	1.12472	0.36364	1.32193	1.65697	1.19896	5.50247	1.0000

Source: Commonwealth Government 2012a, 123

After the onset of the Financial Crisis the stream of GST revenues distributed to the States has become increasingly volatile. Not only has the rate of growth of the GST pool slowed considerably due to lower consumer spending, but the divergent fiscal fortunes of States and Territories in the federation as a consequence of the resources boom has led to significant variations in funding relativities calculated by the CGC to determine specific State's shares of the GST pool (Commonwealth 2010, 5–8). The *GST Distribution Review* (2012, 153–154) notes that after increasing at over eight per cent per annum prior to 2007, since 2008–09 GST revenue growth has averaged only 2.2 per cent — it is expected to rebound to five per cent in future years but is unlikely to recover to pre-crisis rates. Given this volatility in both the size of the GST pool and its distribution there have been growing calls to improve the accuracy of GST forecasts.

State governments clearly need accurate forecasts of GST relativities in order to budget effectively. This concern prompted the *GST Distribution Review* (2012, 151–164) to recommend measures to reduce the volatility of the GST pool and enhance the accuracy of budget forecasts concerning GST distributions. On the announcement of the Review Prime Minister Gillard stated “[I]nstead of States facing penalties for economic growth and rewards for economic underperformance, the GST distribution process should encourage economic reform and better delivery of services, and provide States with certainty” (Gillard in Warren 2012b, 6).

### 3. THE LIMITS OF THE GST FORECASTING REGIME

GST revenue forecasts used by the States for budgeting purposes are the combined result of the total GST revenue for a given year, each State's share of Australian population and each State's relativity calculated by the CGC to meet HFE goals (GST Distribution Review 2012, 79). Using the best available information the Commonwealth forecasts both the total of GST revenue and the populations of each State. While GST pool and population forecasts may, like any estimation, be inaccurate, the real concern is the process used to forecast future GST relativities, or the relative share of the GST pool being allocated to a particular State in a given year of the forward estimates.

The problem arises because under the current regime the CGC only produces an accurate forecast for the current financial year. Given this limitation estimated GST collections are reported in the Commonwealth budget papers as forecasts for the first year, and ‘projections’ for the remaining three years of the forward estimates period. The distinction is that forecasts are attempts to estimate future relativities as accurately as possible using all available data, whereas projections apply to current year relativities to predict future GST distributions. Projections ultimately exclude predictable factors that may change the future relativities across the forward estimates and therefore are not as accurate as forecasts (GST Distribution Review 2012, 78). While the use of such projections may have been defensible during the period of relative economic stability prior to the Financial Crisis, this clearly is no longer the case.

As the *GST Distribution Review* points out, these simplified projections ‘make no allowance for fiscal capacity changes’ of States, as the Commonwealth assumes the latest assessed relativity for the year remains constant for the further three “out years” (GST Distribution Review 2012, 78–79). This approach models the total forecast of the GST revenue pool and anticipated population changes in each jurisdiction, while excluding other predictable factors which will influence future relativities. This methodology has compromised the accuracy of GST projections published in Commonwealth Budget Papers. In the words of the Commonwealth Treasury (Commonwealth Government 2012a, 123):

The Commonwealth's projections of GST relativities for 2013-14 to 2015-16 assume that the States' fiscal capacities will be broadly consistent with the assessment of their relative fiscal assessed differences in the Commission's *2012 Update*. The projections only include adjustments to account for estimated changes in the size of the GST pool, State population shares and the distribution of the National SPPs.

The Commonwealth’s method excludes expected changes in relativities because the Commonwealth’s primary concern is with the size of the GST pool and the Treasury accepts advice from the CGC in terms of how State-specific factors impact on its distribution (CGC 2012a, 112–113). As outlined above, the CGC only publishes its annual update of relativities in the year which they are applied and does not forecast future movements in relativities. For example, the relativities for the 2014–15 fiscal year were published by the CGC in February 2014 based on its analysis of average State circumstances for 2010–11 to 2012–13 (CGC 2012b, 2). The three assessment years which will inform the relativity for each year across the current forward estimates are listed below (Table 2).

**Table 2. Commonwealth Projection Method**

Application year	Commonwealth’s Calculation method	Assessment years required
2011-12	CGC calculated	2007-08, 2008-09, 2009-10
2012-13	CGC calculated	2008-09, 2009-10, 2010-11
2013-14	Commonwealth projections	2009-10, 2010-11, 2011-12
2014-15	Commonwealth projections	2010-11, 2011-12, 2012-13
2015-16	Commonwealth projections	2011-12, 2012-13, 2013-14

Source: GST Distribution Review 2012, 79

In its forward estimates the Commonwealth projections assume each States' fiscal capacity in the future years will remain the same as the current assessed year (GST Distribution Review 2012, 79). Major structural economic changes, such as those associated with the resources boom and its subsequent decline, render this simplistic approach unrealistic. There is now broad-based acceptance that predictable changes in GST relativities over the course of the Commonwealth forward estimates will compromise the accuracy of the projected GST revenues published in the Commonwealth's Budget Paper Number 3. This known inaccuracy has prompted State Treasuries to adopt their own methods of forecasting relativities beyond the inaccurate Commonwealth projections (GST Distribution Review 2012, 79–80).

*The GST Distribution Review* found two fundamental problems with the current State and Commonwealth regime in relation to GST revenue forecasts and projections. It made the blunt assessment that “there is confusion around the purpose and intended accuracy of the Commonwealth projections and secondly, that all GST projections (both Commonwealth and State) are not as accurate as they could be, or should be” (GST Distribution Review 2012, 79). Given such concerns a primary objective of this paper is to establish the extent to which State GST forecasts vary from Commonwealth GST projection over the period until 2015–16 (the period for which there is complete data), and whether there is a systematic bias in the variance and options for reform.

#### 4. VARIATION IN GST FORECASTING — THE EVIDENCE AND ITS CONSEQUENCES

The analysis of State, Territory and Commonwealth Budgets for 2012–2016 presented below (Table 3) highlights variations between the Commonwealth Projections and the State and Territory forecasts which in turn have led to confusion and uncertainty in relation to the final GST allocation each jurisdiction is likely to receive. Table 4 focuses on the extent of the variation between State forecasts and Commonwealth Projections for 2015–16 and reports these variations as a percentage of total GST revenues to highlight the relative significance of the discrepancy for the jurisdiction concerned. To gauge the political significance of this variation Table 4 also reports whether the State forecast used in a given jurisdiction has a decisive impact on the overall operating balance of the budget concerned.<sup>1</sup>

The data presented in Table 4 clearly demonstrates variation between Commonwealth GST projections and State-based forecasts. The fact that this variation is most significant among smaller jurisdictions and the resource-based economies such as Western Australia and Queensland is consistent with the claim that these States are the most vulnerable to changes in GST relativities. While the impact on New South Wales and Victoria is modest, with the revised State-based GST forecasts within three percent of the original Commonwealth projection, this is not true for the other States and has had significant political implications.

The dramatic decline in Western Australia's GST relativity, as evident in both the projections and forecasts in Tables 3 and 4, has resulted in a situation where the Western Australian government is predicting it will receive 17.5 per cent less GST revenue than projected by the Commonwealth in 2015–16, a finding which has sparked an intense political backlash (Franklin 2011). The current and potential future disparities in GST distributions have led commentators and politicians, including the Western Australian Premier Colin Barnett, to suggest that the smaller States of South Australia, Tasmania and the Northern Territory are mendicant, relying on “federal

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<sup>1</sup> We would like to thank a reviewer for suggesting this analysis.

**Table 3. Variations between Commonwealth Projections and State and Territory Forecasts of GST Revenues 2012–13 to 2015–16 (AUD Millions)**

State or Territory	Method to determine Relativity (Own or Cth)	Cth 2012–2013 (forecast)	States 2012–2013	Difference 2012–2013	Cth 2013–2014 (projection)	States 2013–2014	Difference 2013–2014	Cth 2014–2015 (projection)	States 2014–2015	Difference 2014–2015	Cth 2015–2016 (projection)	States 2015–2016	Difference 2015–2016	Total difference
NSW	Own	14,796	14,796	0	15,816	15,685	131	16,680	16,399	281	17,452	17,023	430	842
VIC	Own	11,073	11,041	31.6	11,376	11,592	-216	11,812	12,144	-332	12,435	12,997	-562	-1,078
QLD	Own	9,667	9,667	0	11,194	10,951	243	12,274	11,782	491.7	12,872	12,105	766.8	1501.5
WA	Own	2,797	2,792	5.3	2,109	2,139	-30.3	1,667	1,663	3.9	1,843	1,520	323.5	302.4
SA	Own	4,512	4,512	0	4,782	4,642	140.40	5,104	5,126	-21.70	5,306	5,579	-273	-155
TAS	Own	1,704	1,700	4.4	1,720	1,849	-128.5	1,771	2,059	-287.8	1,832	2,147	-315	-727
ACT	Own	938	938	0	989	994	-4.7	1,069	1,047	22.5	1,120	1,101	19	37
NT	Own	2,714	2,704	9.7	2,911	2,867	44.8	3,123	3,040	82.7	3,214	3,223	-9	128
<b>Cth (Totals)</b>	<b>Cth</b>	<b>48,200</b>	<b>48,150</b>	<b>50</b>	<b>50,900</b>	<b>50,719</b>	<b>181</b>	<b>53,500</b>	<b>53,260</b>	<b>240</b>	<b>56,075</b>	<b>55,695</b>	<b>380</b>	<b>851</b>

Sources: State, Territory and Commonwealth Budgets for 2012–2013

**Table 4. Percentage discrepancy between Commonwealth projection and State Forecasts and impact on Net Operating balance for 2015–16**

State or Territory	Cth 2015–2016 (projection)	States 2015–2016	Difference 2015–2016	Difference as a % of revenue	Forecast 2015–16 Budget Surplus/ Deficit using C'th projection	Forecast 2015–16 Budget Surplus/ Deficit using State forecast
NSW	17,452	17,023	430	-2.4%	587	157
VIC	12,435	12,997	-562	3.4%	1365	1927
QLD	12,872	12,105	766.8	-6.0%	3954	3188
WA	1,843	1,520	323.5	-17.5%	451.5	128
SA	5,306	5,579	-273	5.1%	102	375
TAS	1,832	2,147	-315	17.2%	-348.9	-33.9
ACT	1,120	1,101	19	-1.7%	48.3	29.3
NT	3,214	3,223	-9	0.1%	-245	-236
<b>Cth (Totals)</b>	<b>56,075</b>	<b>55,695</b>	<b>380</b>	<b>0.7%</b>	<b>-</b>	<b>-</b>

“largesse” (Kenny 2013; Denholm 2011). In these circumstances some States, such as Western Australia, may have a political interest in underestimating their relativity to highlight the extent to which they cross-subsidise poorer jurisdictions.

In contrast, States such as Tasmania conceivably have an interest in over-estimating their relativity to obscure the magnitude of the budgetary challenge they face. These political dynamics were evident in Tasmania during the 2013 Federal Election campaign where there was public concern that its share of GST would be cut (Denholm 2013a). In contrast in Western Australia there was discontent in relation to the perceived injustice of receiving less GST than the Northern Territory despite the Northern Territory having only one-tenth of Western Australia’s population (Greber, Dunckley, Sprague and Ludlow 2013). In addition to triggering interstate conflict over the distribution of the GST this volatility has created budget-forecasting challenges for State governments amid uncertainty about how the \$51 billion GST pool will be distributed.

This volatility was the pretence for the States to generate their own relativity forecasts to improve the accuracy and credibility of their respective budgets. These concerns led the Western Australian Treasury to conduct a *Review of Revenue Forecasting* in 2006 to establish how the States’ changing revenue-raising capacities had contributed to errors in State revenue forecasting. At the time of the 2006 review, all the States had used the Commonwealth GST projections for budget forecasting purposes and the review determined that these projections were a significant factor in State budget

forecasting errors (Government of Western Australia 2006, 20). The review recommended that the States' should prepare their own GST revenue forecasts as an alternative to the Commonwealth projections to provide improved modelling for out-years (Government of Western Australia 2006, 28). In Western Australia and Queensland the claim had been that the Commonwealth's projections systematically overestimated the amount of GST they will receive.

Reflecting these concerns, by the 2012 budget season all State jurisdictions had adopted their own methodologies rather than relying on the Commonwealth's GST projections (Giddings 2013). The then Tasmanian Premier Lara Giddings (2013) justified the move on the basis that State based modelling of forecasts are more in line with CGC estimates because they more accurately take into account the effect of one off project funds on their relativities. As noted above, by 2015–16 the discrepancies between the Treasury projections of GST revenue and State forecasts are in the order of 17 per cent for both Tasmania and Western Australia, while in Queensland the State government expected to receive six per cent of the distribution less than that predicted by the Commonwealth. These are substantial sums that significantly impact on the medium term fiscal strategy of the government in question. In the case of Tasmania, the Treasurer attempted to reassure voters that the recovery in the State Budget is based on "hard work and not smoke and mirrors" (Giddings 2012). In contrast Western Australian forecasts amount to some \$302 million less than the Commonwealth projections by 2015–16 and highlight its declining share of GST. In the case of Queensland the predicted decline in GST revenue was highlighted by the Newman Government's *Commission of Audit* that precipitated 14,000 public sector job losses in order to bring recurrent expenditure in line with future income (Queensland Government 2012a).

The States clearly have an administrative incentive to produce independent forecasts of their likely GST distributions given the known inaccuracy of Commonwealth projections. Moreover, as the above commentary suggests, there may be political incentives to manipulate GST forecasts. One way of assessing such claims using existing data is to establish the extent of any systematic bias in State forecasts by comparing the sum of the individual State forecasts with that of the total Commonwealth pool. In theory this figure should be zero because the relativities are used to distribute a fixed revenue pool — any gains a particular State makes due to an improving relativity must be offset by another's loss.

In practice, the total revenue forecast by the States does vary from the size of the Commonwealth pool because each of the States employs their own methods. The data presented in Table 3 highlights that over the four years of the forward estimates the States' expect to receive \$851 million less than the total projected by the Commonwealth. This is a relatively minor variation equivalent to .7 per cent of the GST funding pool for 2015–16 and suggests that there is little systematic bias in forecasting methodologies being used by State Treasuries. This conclusion should reassure those who are concerned about politically motivated manipulation and contradicts the public choice orthodoxy on budget politics which suggests that budget agencies face political incentives to systematically overestimate revenue projections to justify higher levels of short-term public spending (see Niskanen 1975; 1994). While it is reassuring that there is little evidence to suggest there has been systematic manipulation of State GST forecasts, the credibility, and perhaps the accuracy, of such

forecasts would be greatly enhanced if they were prepared in a consistent manner at a national level. The final section of the paper evaluates options for establishing a national framework for forecasting GST revenues.

## 5. OPTIONS FOR REFORMING GST FORECASTS

Budget forecasting will always be an imprecise science, and as *The GST Distribution Review* acknowledges, estimating the GST relativities is particularly difficult given States' fiscal capacities are influenced by significant external factors including exchange rate fluctuation and commodity prices which may disproportionately affect different States (GST Distribution Review 2012, 80). Despite these challenges it is incumbent upon all budget agencies to develop and apply the most appropriate methods available to improve the accuracy and legitimacy of the budget planning process. By this standard the current approach to forecasting future GST relativities in Australia is unacceptable. Given these concerns *The GST Distribution Review* analysed four options for potential reform.

An initial option analysed was whether the Commonwealth Treasury should improve the projections and ultimately create and publish their own forecasts. *The GST Distribution Review* ultimately found that recommending the Commonwealth Treasury to produce accurate forecasts for the forward estimates would be counterproductive. This was because such calculations are largely dependent on data sets provided by the States, which, as *The Review* noted, may or may not want to divulge information concerning their fiscal capacities to the Commonwealth (GST Distribution Review 2012, 80). The other concern of *The GST Distribution Review* was that if the Commonwealth was the body that conducted relativity forecasts, and the CGC subsequently determined the relativity for the current year varied from these forecasts, then the anomaly may undermine the credibility of both agencies (GST Distribution Review 2012, 80). A more practical concern is that tasking the Commonwealth Treasury with preparing GST relativity forecasts would result in unnecessary administrative duplication.

*The GST Distribution Review* also considered the suggestion that the Commonwealth continue to publish relativity projections while making the limitations of the projections "clear and explicit" (GST Distribution Review 2012, 82). Noting that Budget Paper Number 3 should explain what methods are used in order to reduce the risk of confusing readers. Such an approach may reduce confusion, but begs the question: if such projections are so easily misinterpreted, why should they be published at all?

The ultimate recommendation flagged by the GST Distribution Review was that the States should share their relativity data biannually given that the States are ultimately in the best position to know their likely future fiscal position (GST Distribution Review 2012, 81–82). These include own-source revenue estimates for the next four years in accordance with CGC assessments, any potential impacts from announced policy changes on own-source revenue estimates, and expenditure estimates over the next four years by CGC assessment category (GST Distribution Review 2012, 81–82). The Review similarly acknowledged that as the relativity is a determination of the relative fiscal capacity of each State there is a need for the sharing of information between the States to improve each States projections. The proposal being that the

States should encourage the provision of relevant information to a ‘central point of contact’ either being the Commonwealth or a ‘nominated State’ to calculate a joint forecast of the relativities. Interestingly *The Review* argued that it would be inappropriate for the CGC to assume this coordinating function because of a perceived risk of confusing current year ‘actual relativities’ and forecasts across the forward estimates (GST Distribution Review 2012, 81).

While establishing a regime where State Treasuries share relevant budget data to produce relativity forecasts is administratively feasible we argue that it does not address the political realities of intergovernmental conflict within the Australian federation. Such an approach is impractical given growing evidence of declining intergovernmental financial and fiscal cooperation within the Australian federation. For example, Menzies (2012, 418–419) argues that despite the apparent intergovernmental cooperation of the States in non-financial policy arenas, there is an increasing need for the Commonwealth to invest in strategic mechanisms that focus on a long-term intergovernmental agenda. Intergovernmental cooperation within the federation in relation to State funding is especially problematic due to the ‘zero-sum’ nature of States finances, particularly without effective Commonwealth leadership for reform (Eccleston, Warren and Woolley 2013, 27–28). For example, the Intergovernmental Agreement on Federal Financial Relations setting, extending and defining Special Partnership Payments established by the Rudd Government is now regarded as being dysfunctional and ineffective amid increasing intergovernmental tensions and conflict (Menzies 2012, 418). There is little historical evidence from Australia or abroad to suggest that States who are each vying for an increased share of a limited pool of revenue would openly divulge potential revenue streams to each other (Rodden 2000; 2002).

Despite the abovementioned concerns outlined in the *GST Distribution Review*, there is a clear case for the CGC, as an independent and expert agency, to prepare and publish accurate forecasts of GST relativities. The CGC should not only publish revised relativities for the upcoming financial year each June, but it should also provide forecast relativities for the forward estimates period. When considering this option *The GST Distribution Review* acknowledged the Commission had ‘necessary expertise’ while noting that the CGC “has been reluctant to engage in projecting relativities in the past” (GST Distribution Review 2012, 81). We agree with *The GST Distribution Review* that our proposal may place pressure on the CGC given that both State and Commonwealth budget forecasts would be shaped by the CGC’s deliberations, but believe that the Commission is well placed to meet and address such political and technical challenges (GST Distribution Review 2012, 81). Indeed the independent nature of the CGC, unlike the politicised equalisation system in Canada, is regarded as a comparative strength of the Australian HFE regime (Lecours and Béland 2010, 570; 2013; Béland and Lecours 2011). The CGC is a superior alternative to either a consortium of States or the Commonwealth forecasting the overall relativities in the forward estimates. The CGC has the expertise and is a politically neutral body which would reduce the risk of manipulating relativities for political advantage. If one national agency publishes credible relativity forecasts on the best available data then it will enhance the accuracy and credibility of budgets at a State level thus averting the uncertainty and controversy that has been associated with State budgets in recent years.



The current system for calculating GST relativities is based on historical data and it is possible to accurately forecast relativities for the first two years in the forward estimates. Indeed this is exactly what State Treasuries have been doing in recent years by using their own methods. For the third and fourth years in the forward estimates it should be possible to provide reasonably accurate forecasts based on data presented in State and Territory budgets. There would then be a process established whereby States provide bi-annual updates concerning 'out years' to the CGC so it can prepare relativities for the four forecast years ahead of the annual preparation of State budgets. This will involve a regular meeting between the CGC and the Standing Council on Federal Financial Relations. States will then have an opportunity to comment on draft relativity forecasts beyond those for the current year as the case is now. Likewise, all States, Territories and the Commonwealth should give an undertaking to use CGC published forecasts in their respective budgets which in turn adds to certainty and legitimacy of the process.

## 6. CONCLUSION

This paper has argued that there is a clear need to reform the current system for forecasting GST relativities in Australia. This may appear to be a relatively small and technical element within Australia's broad system of federal governance, but we argue that unless the current regime is replaced with a more transparent, consistent and accurate approach to preparing relativity forecasts then the credibility of State budgets and the quality of State budget management will be undermined. This issue was rightly identified by the 2012 *GST Distribution Review*, but we believe that *The Review's* recommendation to improve relativity forecasts by establishing a regime whereby States and territories exchange budget information on a biannual basis is unlikely to succeed based on historical precedent and the parochial tensions which define contemporary Australian federalism.

The paper argues that the CGC should be given a mandate to gather requisite data from the States and Territories and prepare GST relativity forecasts for the States and Territories for the four years of forward estimates published in the Commonwealth budget. The CGC is unique in that it has the necessary expertise to perform this task while being at arms-length from Federal, State and Territory governments. The resulting forecasts will still be subject to the vagaries of ever changing economic conditions and policy settings. However, the fact that they are prepared by an independent agency in a consistent manner will add to their credibility and will counter the lingering concerns that GST forecasts may have been prepared by State governments to further their own political interests. This enhanced credibility should also serve as a more effective fiscal constraint on State governments, placing the onus back on the States to govern within their financial means. Finally, while reforming the GST forecasting is technical in nature and is not as contested as proposals to change the GST distribution formula or rein in special purpose payments to the State, given the fractious nature of intergovernmental financial relations and the looming review of the Australian federation our political leaders might be best served by focusing on technical reforms which should enjoy broad-based support before attempting to tackle more controversial and intractable issues.

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# Regulation of tax agents in Australia

Michael Walpole and David Salter<sup>1</sup>

## ***Abstract***

This article critiques the Australian developments in the regulation and control of tax agents and considers them within the context of both ethics and the policy that encourages tax compliance. The article notes a subtle shift in the relationship between tax agents and their clients from one where the client's (legitimate) interests are paramount to one where similar weight is given to the interests of the Australian Taxation Office and observance of the law.

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<sup>1</sup> Michael Walpole is a Professor in the School of Taxation and Business Law, UNSW. David Salter is a Senior Associate Fellow in the School of Law, University of Warwick. The authors acknowledge the invaluable research assistance of Edmond Wong in the School of Taxation and Business Law, UNSW. Collaboration on this article is an outcome of David Salter's time as an Atax visiting fellow at the School of Taxation and Business Law, UNSW, in 2011.

## 1. INTRODUCTION

The relationship between taxpayers and the tax agents who represent them has been changed in Australia as a result of the enactment the *Tax Agent Services Act 2009 (Cth)* (TASA). In this article a reference to a tax agent<sup>2</sup> means a reference to a professional who assists a taxpayer in understanding and acquitting their obligations under the tax law and who represents the taxpayer in their dealings with the Commissioner of Taxation. The regulation of tax agents in Australia includes regulation of ‘BAS agents’ which are Business Activity Statement agents being professionals who assist business taxpayers in the compilation of their periodic Business Activity Statement (BAS) returns and the other returns identified below in part 4 of this article. The role of tax agents is important in understanding tax compliance and aspects of the practitioner experience have been discussed by Dabner in the *British Tax Review*.<sup>3</sup> Whereas Dabner has examined the role of tax intermediaries in New Zealand Australia and the United Kingdom he has not considered (it not being his purpose to do so) the shift in emphasis in the role of tax intermediaries in Australia that this article does. The authors of this article note the tightening of ‘controls’ on agents in the form of Australia’s now highly regulated and recently revamped regime applicable to tax agents the origins of which date back to the 1920’s. This article identifies how the Australian approach has subtly shifted the principal allegiance that taxpayer representatives have, from their clients alone to compliance with the law and with the wishes of the revenue authority and it discusses the implications of this.

The article starts by considering the critical role of tax agents in relation to taxpayer compliance. It then considers briefly the history of regulation of tax agents before identifying the key features of the new regime. It then goes on to explore how the controls interact with several sets of rules applicable to compliance behaviour. Such rules include severe penalties applicable to tax agents in Australia under the *Promoter Penalties*<sup>4</sup> regime, targeted at the propagation of tax avoidance schemes. It is also necessary to consider the application of the Australian Tax Office’s (ATO’s) *Risk Differentiation Framework*<sup>5</sup> that (anecdotally, owing to obscurity in the operation of the *Framework* ) includes the performance of the tax representative within the matrix of factors that determine the risk to the Revenue posed by the taxpayer.

## 2. THE CRITICAL ROLE OF THE TAX AGENT

A tax agent is a professional who assists taxpayers comply with their obligations under tax law, usually by using the information they are provided with in order to complete the annual income tax return. They also represent taxpayers in their dealings with the revenue authority.<sup>6</sup> Most personal taxpayers in Australia use a tax agent to

<sup>2</sup> “Tax agent” and “BAS Agent” are defined in the TASA by means of lengthy detailed definitions of “tax agent service” and “BAS agent service” under s 90–5 and 90–10 of the TASA.

<sup>3</sup> Justin Dabner “Constraints on the ‘partnership’ model - what really shapes the relationship between the tax administrator and tax intermediaries in Australasia and the United Kingdom” B.T.R. 2012, 4, 526–552 (Dabner).

<sup>4</sup> Division 290 of Schedule 1 *Taxation Administration Act 1953*.

<sup>5</sup> ATO Risk Differentiation Framework Fact Sheet publication (2013) Nat 73993 at <https://www.ato.gov.au/Business/Large-business/In-detail/Risk-Differentiation-Framework/Risk-differentiation-framework-fact-sheet/>.

<sup>6</sup> See note above.

complete their tax return.<sup>7</sup> Taxpayers who are not natural persons frequently use a tax agent too.<sup>8</sup> For companies the public officer signs off the tax return. This is often a tax agent used by the company for this purpose.

The role of the tax agent can be critical to compliance with the tax system. In Australia, the tax agent profession (the demographics of the group and the qualifications expected of them are discussed more fully below) is populated principally by individuals qualified in accounting. Professional accountants are subject to the ethical obligations set by their professional association. Thus, members of the Institute of Chartered Accountants,<sup>9</sup> of CPA Australia<sup>10</sup> and of the Institute of Public Accountants<sup>11</sup> are subject to their respective codes of professional conduct. All participants in the tax system are, of course, also subject to the law and would be subject to criminal penalties for making knowingly false statements, even on behalf of a client. Not all tax agents are members of professional bodies, however, and thus these agents have no professional code derived from that quarter.<sup>12</sup> Furthermore (although this point cannot be taken too far), professional codes tend to emphasise the relationship between the professional and their clients rather than the relationship between the professional and third parties.<sup>13</sup> The relevant literature<sup>14</sup> suggests that the role of the tax return preparer (a tax agent for our purposes) is critical in managing the

<sup>7</sup> Australian Taxation Statistics — in 2011/12, the proportion of individual tax returns filed by tax agents was 72.44%. See <https://data.gov.au/dataset/taxation-statistics-2011-12/resource/f163573b-49a8-483a-bb21-f858a94414ee>.

<sup>8</sup> There is no published data on this but as company and other business tax affairs are complex it is submitted that most business entities would use a tax adviser/agent for lodgement.

<sup>9</sup> See <http://www.charteredaccountants.com.au/>.

<sup>10</sup> See <http://www.cpaaustralia.com.au/>.

<sup>11</sup> See <https://www.publicaccountants.org.au/>.

<sup>12</sup> Cynthia Coleman (Tax Practitioners Board Member) noted that nearly 50% of registered tax agents are not subject to any other professional code than that of the Tax Practitioners Board. “The Tax Practitioners Board: Enforcing ethics of registered representatives” — presentation to Atax Seminar “Ethics and Taxation Advice” 4 November 2013, University of New South Wales. A list of the professional bodies that are recognised by the Tax Practitioners Board can be found in the Tax Practitioners Board Annual Report 2012/13 at Table 3.2.

<sup>13</sup> This might be observed from the tenor of, for example, Compiled APES 110 Code of Ethics for Professional Accountants which notwithstanding its acknowledgement of an accountant’s wider obligations to the public, devotes much of its attention to the risks to the accountant’s integrity and judgment and to the risks to and inherent in the professional/client relationship. Tan (Tan, L. M., “Taxpayers’ Preference for Type of Advice from Tax Practitioner: A Preliminary Examination”, (1999) 20 *Journal of Economic Psychology* 431–447, at 435) reports research by S. Scotchmer ( “The effect of tax advisors on tax compliance” in J.A. Roth, J.T. Scholz (Eds) (1989) 2 *Taxpayer compliance: Social science perspectives* 182–197) which suggests “... tax practitioners do not cheat but are prevented from taking riskless tax positions due to their duty to act in the interest[s] of the[ir] client.”

<sup>14</sup> See, for example, Killian S, Doyle E., (2004) “Tax Aggression Among Tax Professionals: The Case of South Africa” 4(3) *Journal of Accounting, Ethics and Public Policy* and the literature cited therein especially Jackson, B. R., and Milliron, V. C. “Tax compliance research: findings, problems and prospects.” (1986) 5 *Journal of Accounting Literature*, 125-165; Milliron V., (1988) “A Conceptual Model of Factors Influencing Tax Preparers’ Aggressiveness” in Moriarty S. and Collins J., (Eds.), *Contemporary Tax Research* 1–15, University of Oklahoma; and Reckers, P. M. J., Sanders, D. L., and Wyndelts, R. W. “An Empirical Investigation of Factors Influencing Tax Practitioner Compliance” (1991) 13(2) *The Journal of the American Taxation Association*, 30–46. Also see Hite, P. A. and G. McGill: “An Examination of Taxpayers’ Preference for Aggressive Tax Advice”, (1992) 45 *National Tax Journal*, 389–403; Tan, L. M. “Taxpayers’ Preference for Type of Advice from Tax Practitioner: A Preliminary Examination”, (1999) 20 *Journal of Economic Psychology* 431–447; Newberry, K. J., P. M. J. Reckers and R. W. Wyndelts, “An Examination of Tax Practitioner Decisions: The Role of Preparer Sanctions and Framing Effects Associated with Client Condition”, (1993) 14 *Journal of Economic Psychology*, 439–452.



tax compliance process and engendering the right compliance culture. It has been suggested that tax culture is a shared body of beliefs held by a society's tax practitioners and policy makers.<sup>15</sup> The literature is not entirely consistent on the subject of how tax agents influence compliance in that Tan<sup>16</sup> noted a slight propensity for tax preparers to give aggressive advice in situations where there is ambiguity in the law, whilst both Tan and Hite et al<sup>17</sup> have found that taxpayers generally prefer conservative tax advice. Tan has also noted that some research suggests that tax preparers play a dual role in that they can on the one hand enforce the law and on the other exploit ambiguities.<sup>18</sup> The consequence of this critical role of tax agents in contributing to tax culture and of the fact that such a large proportion of individual taxpayers in Australia uses a tax agent to prepare their tax returns means that it is imperative in developing policies and strategies to encourage tax compliance to regulate tax agents. The early work of, inter alia, Jackson and Milliron<sup>19</sup> identified within their "agency theory" analysis<sup>20</sup> the incentives affecting tax preparers. On the one hand, there was an incentive to maximise revenue by efficiently serving their clients and, on the other hand, there was an incentive to fulfil a responsibility (on pain of penalty — in that research situation — borne by their client rather than by the preparer) to the government. This pointed to agency theory as a valid methodology for researching the role of tax preparers in compliance. The recent changes to the tax agent rules in Australia directly influence this agency relationship, making the responsibility to government explicit. The threat of preparer penalties has been demonstrated by Reckers et al to influence preparers to be more accurate in signing declarations and more conservative in advising clients.<sup>21</sup>

Long before the research results referred to above, Australia had evidently recognised the pivotal role played by tax preparers and the long standing practice of regulating the membership of the tax agent community has provided a solid base for the modern approach. The history of such regulation is discussed below.

Before doing so, the background point concerning the ethical environment in which tax agents operate requires elaboration. The suggestion is made that existing professional ethical frameworks may miss sections of the tax agent community as they do not already belong to a regulated (usually self-regulated) professional body. In addition, the ethical guidelines observed by professional bodies such as the various accounting associations have application to a wide variety of professional transactions and relationships and are not aimed specifically at the tax compliance role. Thus,

<sup>15</sup> Livingston M. A. "Law, Culture, and Anthropology: On the Hopes and Limits of Comparative Tax" (2005) 18 *Canadian Journal of Law and Jurisprudence* 119 at 121.

<sup>16</sup> Tan, L. M, "Taxpayers' Preference for Type of Advice from Tax Practitioner: A Preliminary Examination", (1999) 20 *Journal of Economic Psychology* 431–447, 445.

<sup>17</sup> Hite, P. A. and G. McGill, "An Examination of Taxpayers Preference for Aggressive Tax Advice", (1992) 45, *National Tax Journal*, 389–403, 399.

<sup>18</sup> Tan n 16, 434, referring to S. Klepper, M. Mazur and D.S. Nagin "Expert intermediaries and legal compliance: The case of tax preparers" (1991) 34 *Journal of Law and Economics*, 205 - 229.

<sup>19</sup> Jackson B.R., V.C. Milliron, "Tax Compliance Research: Findings, Problems, and Prospects" (1986) 5 *Journal of Accounting Literature* 125–166, 155.

<sup>20</sup> Agency theory is the theoretical analysis of relationships between principals and agents. It is concerned with resolving the problems that arise in such relationships where (inter alia) the goals of the principal and the agent differ. For a discussion, see Kathleen M. Eisenhardt "Agency Theory: An Assessment and Review" (1989) 14, 1, *The Academy of Management Review* 57–74.

<sup>21</sup> Reckers, P. M. J., Sanders, D. L., and Wyndelts, R. W. (1991). "An Empirical Investigation of Factors Influencing Tax Practitioner Compliance" 13(2) *The Journal of the American Taxation Association*, pp. 30–46, 43.

there is an obvious policy imperative for the Australian government to develop a framework within which tax agents should carry out their role that safeguards the interests of the their clients and of the tax system. As indicated, steps in this direction were taken many years ago and that history is described next.

### 3. THE HISTORY OF THE TAX AGENTS' RULES IN AUSTRALIA

Tax agents have been regulated in Australia for almost a century. The *Income Tax Assessment Act 1936-1943* (Cth) established<sup>22</sup> that the Commonwealth Government might enter into arrangements with the various states for the purposes of constituting or recognising various Tax Agents' Boards for each jurisdiction.<sup>23</sup> The Queensland Tax Agents' Board was already in existence, having been established in 1922<sup>24</sup> and the South Australian Board had been in existence since 1924.<sup>25</sup>

The six state Boards (New South Wales, Queensland, South Australia, Tasmania, Victoria, and Western Australia) "...were set up with the aim of registering 'fit and proper' persons to be tax agents"<sup>26</sup> and seem to have functioned well, and in a coordinated fashion. One source seems to suggest that the creation of a national framework that recognised existing State Boards was possibly an initiative of the ATO<sup>27</sup> rather than of the politicians of the day, although this interpretation may be going too far. Were it an ATO initiative it would be a clear manifestation of a strategy on the part of the ATO to engage more closely with the tax agent sector and secure the interests of the revenue.

### 4. THE NEW TAX AGENTS SERVICES REGIME

The entire system was changed with a new legislative regime established under the *Tax Agent Services Act 2009* (Cth) (TASA) leading to the creation of a single national Tax Practitioners Board (Board). The Tax Agent Services Bill 2008 provided for registration of 'tax agents'<sup>28</sup> and Business Activity Statement Agents ('BAS agents')<sup>29</sup>

<sup>22</sup> See, s251H *Income Tax Assessment Act 1936-43* (Cth).

<sup>23</sup> An example of recognition may be found in the *Tax Agents' Board Arrangements Act No. 28, 1943* (NSW). This seems to have arranged that the Board of Appeal established for the hearing of tax appeals under the *Income Tax Management Act No 48 1941* (NSW) would constitute a Tax Agents Board for these purposes.

<sup>24</sup> See also, D'Ascenzo, M. "A proud history: Australia's Tax Agents' Boards", Speech by the Commissioner of Taxation to mark the closing of the six state Tax Agents Boards. Canberra, 18 November, 2009. (<http://www.ato.gov.au/corporate/content.aspx?doc=/content/00221636.htm>, accessed 19 August 2013).

<sup>25</sup> South Australia Income Tax (Amendment) Act 1924.

<sup>26</sup> D'Ascenzo, M. "A proud history: Australia's Tax Agents' Boards", above n 24.

<sup>27</sup> See, L. Edmonds, *Working for all Australians 1910-2010: A brief history of the Australian Taxation Office*, Ch. 4 "The 1940's – Rebirth in adversity" where it is suggested that "The details of the new legislation were worked out at a conference of ATO officials in January 1943 and the amended income tax legislation came into force from 1 August. Its major innovations included a much stronger instalment system known as PAYE (pay as you earn) and the registration of tax agents." <http://www.ato.gov.au/About-ATO/About-us/In-detail/History/Working-for-all-Australians-1910-2010/> (accessed 19 August 2013).

<sup>28</sup> Tax agents are qualified persons who represent a taxpayer in their dealings with the Tax Office and complete and lodge forms and returns on their behalf. It is their services that are defined in TASA rather than a specific definition of "tax agent" or "BAS agent".

<sup>29</sup> BAS agents are paid a fee by business taxpayers to compile a periodic "Business Activity Statement" on their behalf. Their role and the advice they give to their clients are more limited than that of Tax agents.

and for the regulation of such tax agents and BAS agents. The Bill also included an enforceable Code to “provide certainty and clarity for agents as to what is expected of them”,<sup>30</sup> with a view to reducing compliance costs. The rationale for this change is set out in the Explanatory Memorandum that accompanied the Bill.

The Explanatory Memorandum refers (in the usual upbeat style of such things) to a number of impacts that the Bill was intended to have, such as improving:

... the regulatory environment for the provision of tax agent services for a fee or other reward by increasing the consistency in registration and providing appropriate, but flexible, regulation and greater certainty for agents.<sup>31</sup>

This would be achieved through

[t]he establishment of a national Board [that] will benefit tax agents and BAS [Business Activity Statement] agents by providing nationally consistent regulation ... [and which] ... will enable the Board to allocate and use its resources more efficiently, and is expected to increase certainty for agents in the way in which the legislation will be administered.<sup>32</sup>

The Bill recognised that not all the changes would be welcome, but these were mitigated by compensations. The Explanatory Memorandum explained that BAS agents would face barriers to entry, but greater clarity in the regulatory requirements they faced. This would improve taxpayer confidence.<sup>33</sup> According to the Explanatory Memorandum, a broad based regime of sanctions was envisaged which would be “... more constructive and educative administrative sanctions ...”<sup>34</sup> and these would “... encourage agents to comply with the Code and ... improve their performance.”<sup>35</sup>

It was also suggested that this regime with its emphasis on civil rather than criminal sanctions, which it replaced, would be efficacious “... by providing appropriate consequences for misconduct and by providing effective disincentives to act inappropriately.”<sup>36</sup> This, it was said, would “... benefit agents and the integrity of the tax system ...”<sup>37</sup>

Thus, the State-based approach has become a single national system under the TASA which now regulates all tax agents and also regulates BAS agents. The inclusion of this latter category of agent was necessary as a result of the introduction of the Goods and Services Tax (GST) and consequential reforms which resulted in the need for taxpayers to complete periodic returns that are not income tax returns. Such returns include, usually quarterly, information about the business’s obligations and compliance activities relating to GST, Pay-as-you-go (PAYG) income tax instalments, PAYG tax withheld from payments to third parties, fringe benefits tax (FBT)

<sup>30</sup> Explanatory Memorandum to Tax Agent Services Bill 2008, page 5.

<sup>31</sup> Id, page 4.

<sup>32</sup> Id, page 5.

<sup>33</sup> Id.

<sup>34</sup> Id.

<sup>35</sup> Id.

<sup>36</sup> Explanatory Memorandum to Tax Agent Services Bill n 30 above, page 5. Further description of the civil penalties regime is available on the Board website at [http://www.tpb.gov.au/TPB/Subsidiary\\_content/Reg\\_info\\_sheets/0295\\_Civil\\_penalties.aspx](http://www.tpb.gov.au/TPB/Subsidiary_content/Reg_info_sheets/0295_Civil_penalties.aspx) (accessed January 2014). This explains that civil penalties, unlike criminal penalties, do not involve imprisonment or criminal convictions.

<sup>37</sup> Explanatory Memorandum to Tax Agent Services Bill n 30 above, page 5.

instalments on benefits provided to employees, luxury car tax (LCT) payments, wine equalisation tax (WET) payments by certain businesses, and fuel tax credits entitlements of some businesses.<sup>38</sup> Such BAS providers are commonly qualified as bookkeepers whereas tax agents, as already mentioned (see pages 336 and 337 above), are commonly qualified as accountants. Not all accountants are members of professional associations with codes of practice. Moreover, at the time when registration of BAS agents was being implemented even fewer bookkeepers would have been members of professional bodies, thus providing further incentive to regulate the ethical framework within which such tax professionals operate. This discussion of BAS agents leads to the next topic in this article which deals with who may act as a tax agent in Australia.

## 5. ELIGIBILITY REQUIREMENTS

The TASA sets out criteria for eligibility for registration as a tax agent or BAS agent.<sup>39</sup> These requirements cover individuals, partnerships and companies. These indicate that individuals<sup>40</sup> aged 18 years or more are eligible for registration subject to the satisfaction of the Tax Practitioners Board (Board) as to their being a fit and proper person (discussed further below at page 343 onwards) and their meeting certain requirements prescribed by regulations concerning, principally, their educational qualifications and their professional experience.

These same requirements are incorporated into the eligibility requirements for registration of companies as each director of the company must meet the same eligibility requirements as an individual; and the eligibility for registration of partnerships in that each partner must meet the same eligibility requirements as an individual or in the case of a partner that is a company, those applicable to a company.<sup>41</sup>

Companies and partnerships involving companies must meet further requirements regarding their capacity to provide competent services in terms of having enough tax agents and requirements that the company not be under administration nor have been convicted of a serious tax offence (defined term) involving fraud or dishonesty during the previous 5 years.<sup>42</sup>

The TASA regime is now well established after four years.<sup>43</sup> The Board's Annual Report 2011–2012<sup>44</sup> indicated that by 30 June 2012 over 52,000 agents had been registered<sup>45</sup> and that this figure included not only tax agents and BAS agents but also other professionals "... who provide services with a tax advice element, such as

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<sup>38</sup> See, the Australian Taxation Office 'Activity statements home' at <http://www.ato.gov.au/Business/Activity-statements/> (accessed 19 August 2013).

<sup>39</sup> See TASA at Div 20.

<sup>40</sup> Section 20-5 TASA.

<sup>41</sup> Id.

<sup>42</sup> Id.

<sup>43</sup> The Board commenced operation, on 1 March 2010, when the TASA commenced. ([http://www.tpb.gov.au/TPB/Subsidiary\\_content/Annual\\_report\\_and\\_strategic\\_plan/0253\\_2010\\_Annual\\_Report.aspx](http://www.tpb.gov.au/TPB/Subsidiary_content/Annual_report_and_strategic_plan/0253_2010_Annual_Report.aspx)).

<sup>44</sup> Australian Government, *Tax Practitioners Board Annual Report 2011–12* (TPB Report 2011–12).

<sup>45</sup> The Board Report 2011–12 note n 44 above page ii.

quantity surveyors and research and development consultants”.<sup>46</sup> There were about 38,000 tax agents and over 14,000 BAS agents registered.<sup>47</sup>

The Chairman of the Board indicated in the Report that its purpose is to “... regulate ... tax and business activity statement (BAS) agents to protect consumers.”<sup>48</sup> And that the Board “... aims to assure the community that tax and BAS agents meet appropriate standards of professional and ethical conduct.”<sup>49</sup>

This is achieved

by:

- administering a national system to register tax and BAS agents, making sure they have the necessary qualifications, experience and personal attributes to be registered
- regulating tax and BAS agents through measured responses to breaches of the *Tax Agent Services Act 2009* (TASA)
- taking Federal Court action against unregistered agents, seeking civil penalties and injunctions where appropriate
- providing information, assistance and guidance to agents and would-be agents about registration, professional conduct and practice issues.<sup>50</sup>

The Board is thus not merely a registering body but is active in “policing” the profession, which is as it should be in the case of a regulatory system. The Board’s 2011–12 Annual Report revealed that seven tax agents/BAS agents were de-registered for breaches of the Code of Professional Conduct or on grounds related to their lack of fitness and propriety. Several other agents had voluntarily surrendered their registration when they became aware of impending action against them by the Board.<sup>51</sup>

The Board also “... commenced the first civil penalties actions under the TASA. In the first case decided, in May 2012, the Federal Court of Australia imposed a \$30,000 penalty on an unregistered agent for preparing tax returns for a fee without being registered”.<sup>52</sup>

These actions arose from investigations undertaken by the Board which finalised 17 actions during the year reported and had 12 still underway at 30 June 2012.<sup>53</sup> There were four investigations leading to applications by the Board to the Federal Court to consider the imposition of civil penalties on persons allegedly practising as tax preparers although unregistered.<sup>54</sup>

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<sup>46</sup> Id.

<sup>47</sup> Id.

<sup>48</sup> Id.

<sup>49</sup> Id.

<sup>50</sup> Id.

<sup>51</sup> Id, page iii.

<sup>52</sup> Id page iii.

<sup>53</sup> Id page 45.

<sup>54</sup> Id.

The Board has since increased its activity significantly reporting in its 2012–13 Annual Report that having had 12 investigations on hand at the start of that year it commenced 1,133 investigations, finalising 952 with 193 still in progress at the end of June 2013.<sup>55</sup>

The Board has also issued a number of Guidelines concerning educational standards for registrants that will ultimately become law once tabled in Parliament,<sup>56</sup> and an important Explanatory Paper setting out its interpretation of the requirement that agents must be ‘fit and proper’ persons as required under s 20-A of the TASA. Prior to this article being published, this paper had been the subject of consultation and had been issued as an exposure draft before finalisation.<sup>57</sup>

## 6. THE ‘FIT AND PROPER PERSON’ REQUIREMENT

As discussed above (page 342), the requirement that a tax agent or BAS agent be a fit and proper person is a requirement for both initial and continued registration. It will also be recalled that it is also a requirement where companies are registered (or partnerships of companies) that the tax agent directors be fit and proper persons. Clearly, if one of the objects of the regulation process is to secure improvement in the tax compliance culture it is important to ensure that honest and professional persons are involved in representing taxpayers in their submissions to the ATO.

It is an important feature of the system that the requirement of fitness and propriety in one’s practice is related to the Code of Professional Conduct (Code) — discussed below (page 344 onwards) — which is found in the TASA, in that a breach of this Code may have implications for a finding as to whether an agent or applicant is regarded as fit and proper. The Board has explained in its Explanatory Paper that when taking action against an agent its options include such things as the imposition of sanctions for breach of the Code, application for the imposition of civil penalties for breach of the civil penalty provisions, and the termination of an agent’s registration on the basis that the agent is no longer a fit and proper person.<sup>58</sup>

The Explanatory Paper also states that “[i]t is possible that matters impacting on the fitness and propriety of an agent may also be relevant to a finding under the Code or under one of the civil penalty provisions.”<sup>59</sup>

<sup>55</sup> Australian Government, *Tax Practitioners Board Annual Report 2012–13* page 47.

<sup>56</sup> See, Australian Government, *Tax Practitioners Board Annual Report 2010–11* page 32. A useful table summarizing the qualifications required may be found at [http://www.tpb.gov.au/TPB/Qualifications\\_and\\_experience/0240\\_Qualification\\_and\\_experience\\_requirements\\_for\\_tax\\_agents.aspx](http://www.tpb.gov.au/TPB/Qualifications_and_experience/0240_Qualification_and_experience_requirements_for_tax_agents.aspx) (Accessed January 2014).

<sup>57</sup> The Board Report 2010–11 n 56 page 32.

<sup>58</sup> Explanatory Paper TPB (EP) 02/2010 *Fit and proper person*, page 4. On its website, the Board summarizes the civil penalties as follows: (1) Penalties applying for conduct that is prohibited without registration and (2) Penalties applying for conduct undertaken by a registered entity. The first category includes receiving a fee/reward for work only a registered agent should undertake (up to \$42,500 fine for individuals); advertising tax agent services whilst unregistered; misrepresentation of registration. Penalties for conduct in the second category include a registered entity making a false or misleading statement (especially) to the Commissioner (up to \$42,500 fine for individuals); use of deregistered entities to deliver services; signature of declaration/statement required by a taxation law or BAS provision, which was not prepared by the registered entity or another registered entity or agent (up to \$42,500 fine for individuals).

<sup>59</sup> Explanatory Paper TPB (EP) 02/2010 *Fit and proper person*, page 4.

In cases where the Board is satisfied that there has been a breach of the Code the sanctions available to it for the breach are a caution given in writing<sup>60</sup> or an order that requires the tax agent or BAS agent to take certain steps including any of: completing a specified course of education/training, providing the relevant services only under supervision by another agent, providing only specified services.<sup>61</sup> The registration of an agent might also be suspended or even terminated.<sup>62</sup>

## 7. OBLIGATIONS OF TAX AGENTS UNDER TASA

The obligations of tax agents are to be found in the Code which is enacted in TASA and which consists of 14 principles. For the sake of thoroughness, these principles are set out in full in the Appendix to this article.<sup>63</sup> The principles fall into the five broad categories of ‘Honesty and integrity’; ‘Independence’; ‘Confidentiality’; ‘Competence’ and ‘Other responsibilities’.

There are three components in the Honesty and integrity category. These are (unsurprisingly) that the agent must act with honesty and integrity, must comply with tax laws in relation to their personal affairs and must account for money and property held in trust for a client. Under Independence, there are requirements that the agent act lawfully in the client’s best interests and have adequate arrangements for the management of conflicts of interest arising from their work as a tax agent or BAS agent. The Confidentiality principle is simply that an agent must not, without a client’s permission, disclose information relating to a client’s affairs to anyone, except there is a legal duty to do so.

The Competence principle is heavily emphasised in that it has four requirements. First, the service provided must be provided in a competent fashion; secondly, the agent must maintain the relevant knowledge and skills; thirdly, the agent must take reasonable care in ascertaining the state of affairs of the client to the extent that this is relevant to any statement made or a thing done on behalf of a client, and, fourthly, the agent must take reasonable care to ensure that the tax laws are applied correctly to the circumstances in which the advice is given.

Finally, the ‘Other responsibilities’ category covers four matters that are essentially administrative in character but, nevertheless, very important. These include the following requirements: not to obstruct the administration of tax law; to advise a client of rights and obligations pertaining under the relevant laws; to maintain professional indemnity insurance; and to respond in manner that is timely, responsible and reasonable, to requests and directions of the Board.

All these principles are elaborated upon in a further Explanatory Paper relating to the Code published by the Board.<sup>64</sup> The Explanatory Paper explains how the Code applies only to registered agents, but notes that there are also civil penalty provisions available that might apply to persons who are not registered but have engaged in conduct that brings them within the relevant penal provisions of the TASA. Further, the same

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<sup>60</sup> Id, with reference to s30–15 TASA.

<sup>61</sup> Id, pages 4–5 with reference to s30–20 TASA.

<sup>62</sup> Id, pages 4–5 with reference to s30–20 TASA.

<sup>63</sup> See, s30–10 TASA.

<sup>64</sup> Explanatory Paper TPB 01/2010 Code of *Professional Conduct*.

conduct might be both a breach of the Code and be within the civil penalty provisions of TASA.<sup>65</sup>

In this Explanatory Paper, the Board has identified each of the terms and expressions used in the Code that it is possible to define or explain, ranging from ‘honesty and integrity’ through ‘taxation laws’ and ‘personal affairs’ to ‘account’ and ‘best interests of your clients’. By this means it has given guidance as to the ambit of the Code and to the matters in which it will take an interest.

Some of these words and phrases have a specific meaning when used in a particular context. For example, one of the questions concerning whether a person has acted with ‘honesty’ and ‘integrity’ is expressed as “is the person of such reputation and ability that officers of the ATO may assume that taxation returns lodged by the agent have been prepared by the agent honestly?”<sup>66</sup> This emphasizes the perspective of the ATO rather than that of (for example) a reasonable observer. This is despite the fact that the Code operates within a regulatory system intended to benefit taxpayers and to secure the interest of taxpayers in being reliably represented, sometimes against the ATO. It might be perceived that the interests of the ATO are weighted more heavily in an environment where there is a risk that professional self-interest or the interests of a client will prevail. In fact, the approach adopted here might be perceived as aligning the professional self-interest associated with remaining registered with the interests of the ATO in having tax agents “on their side”.

‘Personal affairs’ is, sensibly narrowed by reference to personal *tax* affairs and the Explanatory Paper states that

... ‘personal affairs’ refers to a tax agent’s or BAS agent’s personal taxation obligations, including timely lodgement of ... [various tax returns and statements] ... and payment of ... [various contributions and instalments].<sup>67</sup>

It is widened, however, to include the affairs of the professional practice, for example, maintenance of registration<sup>68</sup> There is an emphasis on professional competence and on the ability of the tax agent to service clients – the Explanatory Paper explicitly notes that the agent must have enough registered professionals to provide services competently and to properly supervise the services provided to clients.<sup>69</sup>

This is followed by examples, drawn from the Explanatory Memorandum to the Tax Agent Services Bill 2008, of circumstances to be taken into account in deciding whether the agent has properly complied with taxation laws in relation to their own personal affairs.

These are, in turn, followed by a detailed explanation of what must be done by a tax agent or BAS agent in order to comply with the requirement that they account for money and property held in trust for clients. This explanation spells out the type of actions one would regard as normal and sensible such as keeping such monies separate

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<sup>65</sup> Id, pages 6–7.

<sup>66</sup> Based on *Re Su and Tax Agents’ Board of South Australia* 82 ATC 4284 at 4286, referred to in the Explanatory Paper n 64 above page 10.

<sup>67</sup> Explanatory Paper n 64 above, page 11.

<sup>68</sup> Id.

<sup>69</sup> Id, page 12.



from their own funds,<sup>70</sup> only dealing with the money as instructed, and keeping a regular account of it.<sup>71</sup>

The requirement in the Code that a tax agent or BAS agent must act lawfully in the best interests of the client leads the Board into an interesting discussion of this aspect. The Explanatory Paper goes to some lengths to explain how this does not mean that an agent owes a fiduciary duty to the client, although the agent/client relationship is very similar to a fiduciary one. A fiduciary relationship is one in which the interests of the agent must not be allowed to conflict with those of the client and would imply supremacy of the interests of the client. The Explanatory Paper explains that the taxpayer client's interests are not paramount to the extent that the agent can depart from the law.<sup>72</sup> The supremacy of the law and the duty of ensuring proper compliance rather than the client's wishes when they are in conflict are made very clear. The Explanatory Paper is also emphatic in its statement that "... the Code of Conduct does not create a fiduciary duty between an agent and their client".<sup>73</sup> The stress laid on the lack of a fiduciary relationship means that the client's interests cannot be seen as overriding. This is a departure from the usual approach to the professional/client relationship which places the interests of a client above other interests (although not above the law). One perception might be that this departure from the more common emphasis on the client's interest has been adopted because a fiduciary relationship would operate counter to the interests of the revenue authority. It could equally be argued, of course, that all that this represents is an aspiration to ensure that compliance with tax law is achieved.

Notwithstanding the Explanatory Paper's stress that the relationship is not a fiduciary one, it does draw, slightly confusingly, on examples of fiduciary relationships to illustrate breaches that the Board might use in determining whether an agent has breached the Code in dealings with a client.<sup>74</sup> Further statements also deal with the contractual relationship between client and agent and stress that the agent's duties are not wholly based on that contract. Thus, the agent's obligations under the Code have to be considered, not just the contractual terms of their engagement.<sup>75</sup> This is possibly another manifestation of the policy to align the interests of the ATO and of the compliant agent, counter-balancing an alignment of the interests of the agent with those of the client exclusively.

It is interesting that there is no explanation or expansion in the Explanatory Paper of the role of the agent in circumstances where such agent might be regarded as not pursuing a client's interest with adequate vigour or aggression – as where, for example, the law is unclear and an opportunity for avoidance has arisen. Nor is there, in this part of the Explanatory Paper, any discussion of the interest of the client where the agent has not taken advantage of a tax law that operates in the client's favour. It is perhaps understandable that the Explanatory Paper does not do so. First, it may be thought that aspects of negligence are covered by the contractual relationship between the parties or, perhaps, by the possibility of suing an agent for damages in tort if the advice given is negligent; secondly, the question of competence is addressed

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<sup>70</sup> Id, page 13.

<sup>71</sup> Explanatory Paper n 64 above, pages 13–14.

<sup>72</sup> It is not suggested that a fiduciary could do this either.

<sup>73</sup> Explanatory Paper n 64 above, page 14 at paras 50, 51 and page 15 para 53.

<sup>74</sup> Id, pages 14 and 15.

<sup>75</sup> Id, page 15, para 55.

elsewhere in the Explanatory Paper under relevant aspects of the Code.<sup>76</sup> These aspects focus on technical competence and maintenance of skills and knowledge. Once again, however, this focus shows that the emphasis in this professional relationship is not on the overriding interests of the client.

The Board has signalled clearly, and as intended by the TASA, that agents are not (at least under the statute) expected to pursue the best interests of their clients with the same exclusive attention to the client's interests above other constraints (the law permitting) as other professions such as lawyers. TASA and the Code seem to place at least as great an emphasis on compliance with the law as on the interests of a client. At first, it seems as if the Explanatory Paper gives an example of the difference between an agent's duties and those of a fiduciary by referring to a s264<sup>77</sup> notice (which requires a person to immediately provide to the Commissioner of Taxation any documents and records they hold that relate to a taxpayer's tax liability). The Paper seems to suggest (on one reading) that an agent might have to provide requested documents to the ATO, whereas a lawyer must not, in cases where the documents may be subject to lawyer/client privilege and the client has not waived the privilege or the status of the documents needs to be ascertained before they are handed over.<sup>78</sup> A later part of the Explanatory paper, however, reasserts client privilege in certain documents even if held by a tax agent or BAS agent.<sup>79</sup> This may be an aspect of the relationship, albeit non-fiduciary, that a Court in Australia will have to determine. This is discussed further below under the topic of confidentiality.

One of the examples of the requirement that the agent must act in the best interests of the client is that (based on the general law applicable to fiduciaries)<sup>80</sup> a conflict between the agent's own interests and those of the client should be avoided. This means that there is an expectation that agents will have in place a means of managing such conflicts. This is an explicit part of the Code and is covered at some length in the Explanatory Paper.<sup>81</sup> The guidance provided here (which is to develop systems to control avoid and disclose conflicts of interest) is sound and is well aligned with similar guidelines on dealing with conflicts of interest that are provided by professional bodies, such as the CPA Australia.<sup>82</sup>

The requirement of confidentiality in Principle 6 of the Code similarly parallels the various guidelines for accountants in Australia.<sup>83</sup> In both cases the fact that the law may override any general principle of confidentiality is stressed. Agents can be in no doubt that when asked for information they will have an obligation to provide it if the law supports the request. Indeed, the Explanatory Paper sets out several examples of circumstances in which the law overrides confidentiality which are said to include:

providing information to the Tax Practitioners Board under a notice issued pursuant to section 60-100 of the TASA.

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<sup>76</sup> Id, page 23 onwards, paras 93–117.

<sup>77</sup> See, s 264 *Income Tax Assessment Act 1936*.

<sup>78</sup> Explanatory Paper n 64 above, page 17, para 63.

<sup>79</sup> Explanatory Paper n 64 above, paras 92 and 104.

<sup>80</sup> See, Ysiah Ross, Peter MacFarlane, *Lawyers' Responsibility and Accountability – Cases, Problems & Commentary* 4<sup>th</sup> Ed, Lexis Nexis 2012, para 11.2 for cases and examples.

<sup>81</sup> Explanatory Paper n 64 above, page 17 para 64 — page 20, para 77.

<sup>82</sup> See, for example, section 220 of *APES 110 Code of Ethics for Professional Accountants*, December 2010.

<sup>83</sup> See, section 140 of *APES 110 Code of Ethics for Professional Accountants*, December 2010.

providing information to a court or tribunal pursuant to a direction, order, or other court process, to provide that information.

providing information or documents to the ATO under a notice pursuant to section 264 of the Income Tax Assessment Act 1936 (ITAA 1936). This requirement is subject to that material being properly withheld by the tax agent or BAS agent under legal professional privilege.

providing information or documents to the ATO pursuant to section 353-10 of Schedule 1 to the Taxation Administration Act 1953 concerning indirect taxation laws (including GST).<sup>84</sup>

The assertion of legal professional privilege is an interesting feature of this list of examples. The tax agent or BAS agent is not directly required by legal professional privilege to withhold documents from the ATO. It is conceivable that circumstances could arise where the obligation does exist (such as where the tax agent is also a lawyer or is covered by a client's legal privilege in a given situation, such as where the tax agent is the agent of the lawyer and the client's privilege extends to the material held by the tax agent on behalf of the client, through the lawyer). It seems that this may be a grey area requiring judicial consideration.

The Explanatory Paper also considers each of the other principles of the Code. As has been mentioned, these include a requirement that the agent's service or that provided on the agent's behalf, is provided competently. In relation to competence, the Board explains that this requirement includes an expectation that agents will maintain their skills so that they themselves remain competent as well as an expectation that they provide their services in a competent manner.<sup>85</sup> It is noticeable that the duty that this addresses is, once again, framed as an obligation in two directions. Not only must the client be able to rely on the tax agent's work, the ATO must also be able to do so:

A tax agent or BAS agent will be competent if the agent possesses such skill, ability and knowledge required to perform a tax agent service that clients may entrust their taxation affairs to the agent's care and officers of the ATO may rely upon client returns or other documents prepared by the agent.<sup>86</sup>

This demonstrates again that the Australian tax agent regime is intended to regulate the service from the perspective of the client who should be able to rely on the advice and actions of the agent and expect that the obligations of the agent under the law have been met – but the ATO is also to be able to rely on the actions of the agent and be assured that they have acted competently and diligently. The agent, thus, represents the interests of both the taxpayer and the ATO. There can be no doubt that this must create tensions – as noted by Dabner who has said that there is "... a cohort within the profession [that] appears to be reluctant to acknowledge any duty to the system and is therefore hardly likely to embrace the spirit of a partnership relationship with the ATO".<sup>87</sup>

Another part of the Code that has benefitted from elucidation by the Board is the requirement in Principle 9 of the Code, that a tax agent or BAS agent needs to take

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<sup>84</sup> Explanatory Paper n 64 above, page 22, para 92.

<sup>85</sup> Id, pages 23-24, paras 96–98.

<sup>86</sup> Id, para 96.

<sup>87</sup> Dabner n 3 above, page 535.

reasonable care in ascertaining a client's affairs "... to the extent that ascertaining the state of those affairs is relevant to a statement ... [the agent is] ... making or a thing ... [they] ... are doing on behalf of the client".

This expectation may cause some discomfort for new registrants<sup>88</sup> in that it implies an expectation that they should actively enquire into a client's affairs to an extent that, before the introduction of the Act, they might not have done. Indeed, Dabner has noted that respondents to his research revealed that they would not divulge to the ATO the details of clients that are not compliant.<sup>89</sup>

The Explanatory Paper explains that the extent of inquiry/knowledge is limited to the extent that the state of those affairs is relevant to a statement the agent is making or a thing the agent is doing on behalf of a client. That is, the requirement to take reasonable care is limited by the scope of the engagement between the tax agent or BAS agent and the client.<sup>90</sup>

However, the Explanatory Paper does explain (relying on the Explanatory Memorandum that accompanied the 2008 Bill) that active enquiry may be needed. It illustrates this point by explaining that the 'reasonable care' expectation may require an agent to ask questions when seeking information. That the questions should be based on their professional knowledge and experience and if there is reason to doubt the information that the client has provided they must take actual steps and make reasonable enquiries to satisfy themselves as to the accuracy and completeness of the information provided.<sup>91</sup> This emphasizes a professional but critical approach to the information provided by a client.

Statements by the client that seem plausible and consistent with their other statements and that reveal no basis on which to doubt their reliability may be accepted without further checking.<sup>92</sup> But where the information supplied is implausible or inconsistent with information provided in the past, further enquiries are required.<sup>93</sup> This does not extend to an expectation that the agent will audit, or examine records etc., but the Explanatory Paper is explicit in its statement that "... a tax agent or BAS agent does not discharge their responsibility in such a case by simply accepting what they have been told ...".<sup>94</sup>

The defence that an agent was simply following instructions (presumably accompanied by an indication that the client has signed the tax return or other document) is clearly not available under this new regime; the plausibility of the client's information must be tested.

If the Australian position described above does not already amply illustrate that the agent under the Australian system is also the agent of the ATO the explanation of the next Principle (11) of the Code would appear to reinforce the point. It deals with the

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<sup>88</sup> This is anecdotal and is derived from a social conversation between one of the authors and a newly registered BAS agent.

<sup>89</sup> Dabner n 3 above, page 536.

<sup>90</sup> Explanatory Paper n 64 above, para 119.

<sup>91</sup> Id, para 128.

<sup>92</sup> Id, para 129.

<sup>93</sup> Id, para 130.

<sup>94</sup> Id, page 31, paras 128 -132.

requirement that an agent “... must not knowingly obstruct the proper administration of the taxation laws”.

There is a narrow example of an exclusion from this rule made in a reference to professional privileges rules and guidelines which explain that a tax agent or BAS agent is not in breach of this requirement when reliance is placed on the rights of the client or agent to withhold documents or not to provide information.<sup>95</sup>

A tax agent or BAS agent does not breach this requirement by relying on the agent’s or the client’s rights to withhold documents or to not provide information. Examples of such rights may include legal professional privilege or the ATO accountant’s concession set out in the published ‘Guidelines to Accessing Professional Accounting Advisor’s Papers’.<sup>96</sup>

Various omissions may also amount to obstruction – such as repeated failure to attend appointments, and failure to reveal how access to information might be obtained etc.<sup>97</sup>

The contrary view, of course, is that the mere fact that a person is not permitted to obstruct the administration of the law does not make that person a law enforcement agent, they are merely ensuring there is compliance with the law.

It is noticeable all the same that the balance of obligations borne by an agent is explicitly pushed further in the direction of the agent being an agent of the tax system rather than merely a champion of the taxpayer.

The taxpayer who is seeking a champion in this environment may be disappointed to read the explanation of the Code that a tax agent or BAS agent must “... advise ... [their] ... client of the client’s rights and obligations under the taxation laws that are materially related to the tax agent services you [the agent] provide”.<sup>98</sup> This does not mean that the client can be assured of a universal advice on all aspects of the tax law and the various opportunities for tax minimization that may be open to them. The Explanatory Paper explains how this would be addressed in an engagement letter which may include, inter alia, providing advice on:

the nature of self-assessment, including the Commissioner’s ability to amend an assessment within a certain time after the original assessment, impose penalties and issue rulings on which clients may rely:

- the client’s obligation to keep proper records and the consequences of not doing so;
- that the responsibility for the accuracy and completeness of the particulars and information required to comply with the taxation laws rests with the client;
- the application of the safe harbour provisions contained in the Taxation Administration Act 1953; and

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<sup>95</sup> Explanatory Paper n 64 above page 33, para 140.

<sup>96</sup> Id.

<sup>97</sup> Id, para 145.

<sup>98</sup> This is Principle 12 of the Code.

- where necessary, the rights or options available to clients, including how to seek a private ruling and how to object or appeal against adverse decisions made by the Commissioner.<sup>99</sup>

There is no mention in this advice that complies with the law, but which might well include advice about arrangements to minimise tax.

It seems clear from this that there is no promise in the agent/client relationship that a client be provided with the most advantageous tax advice, only that the client will have an understanding of the rights under the contract with the tax agent or BAS agent, the (relatively narrow) manner in which the safe harbour provisions might protect them from the consequences of delay and similar unprofessional conduct of their tax agent, and of the obligations in terms of record keeping, completeness of information etc. It seems the obligation to provide the best advice<sup>100</sup> is merely implied.

It might be concluded from the Board's expressed intention as to how it will administer the Code that the statutory and regulatory environment affecting tax agents and BAS agents has explicit obligations on the part of agents that operate to the benefit of their clients and to the benefit of the operation of tax laws. The consequence of a breach of these obligations by the agent may be a suspension or cancellation of registration at one extreme or a caution or requirement to undertake remedial education at the other. A breach of the Code may lead the Board to consider that an agent is not a fit and proper person. Thus, the Code is a significant advance on what was in place under the previous Tax Agent Registration Boards because, whilst those Boards could deregister agents on the grounds that they were not a 'fit and proper person', they did not have a Code of Professional Conduct against which to measure the propriety of a person's conduct or fitness to act as a tax agent. In addition, it should be borne in mind that breach of the Code could be conduct that triggers a civil penalty. For example, breach of the requirement to act honestly might trigger a civil penalty if the dishonesty takes the form of making a misleading statement to the Commissioner<sup>101</sup> and would afford the Board a choice of sanctions to impose on the offending agent. Under the previous system this choice would not have been so clearly available to the Tax Agent Registration Boards. The new system in Australia has fundamentally changed the ground rules.

## 8. HOW DOES THE ATO INTERACT WITH TAX AGENTS AND BAS AGENTS?

This article has noted that from a policy perspective it is desirable that the ATO be able to control the compliance environment and culture through the way tax agents operate. It has also attempted to demonstrate how the tax agent and BAS agent groups are closely regulated. This should not be taken, however, as an indication that the TASA and the Board operate under the direction of the ATO. On the contrary, the Board is a separate statutory body.<sup>102</sup> The ATO is, of course, one of its stakeholders.<sup>103</sup> As the TASA has evidently established an administrative environment in tax under which the ATO appears more able to rely on tax agents than they were

<sup>99</sup> Explanatory Paper n 64 above, pages 37–38, para 156.

<sup>100</sup> See, for example, the NSW Supreme Court decision in *Bell v Vahexi Pty Ltd* 99 ATC 4055.

<sup>101</sup> Breach of s 50-20 of TASA.

<sup>102</sup> See,

[http://www.tpb.gov.au/TPB/About\\_us/Our\\_stakeholders/TPB/About\\_us/0343\\_Our\\_stakeholders.aspx](http://www.tpb.gov.au/TPB/About_us/Our_stakeholders/TPB/About_us/0343_Our_stakeholders.aspx).

<sup>103</sup> Id.

under the previous statutory regime, but one in which the ATO does not actually regulate the profession, one wonders how this translates into the manner in which the ATO conducts its relationship with agents.

The introduction to the internet-based Tax Agent Induction Package includes an introductory welcome letter from the relevant Deputy Commissioner of Taxation. The letter used in 2012 included in part:

... Registered tax agents should also ensure they keep their personal tax obligations, and those of entities they are associated with, up to date. Not meeting your personal tax obligations puts you at risk of prosecution action. Instances where registered tax agents do not meet their personal obligations will be forwarded to the Tax Practitioners Board for consideration as potential breaches of the code of professional conduct under the *Tax Agent Services Act 2009*.

Effective tax administration relies heavily on a capable, sustainable and well regulated tax profession. Registered tax agents such as you are vital in influencing voluntary compliance and ensuring taxpayers understand their rights and obligations.

Given the central role you play as a registered tax agent, we closely monitor your clients' levels of compliance and seek your assistance and active support to ensure the integrity of the tax system. Where we see trends outside the norm or outside of published benchmarks in certain industries, we will check your clients' tax returns and activity statements and your practice ...<sup>104</sup>

It is evident from this letter that the agents it was sent to should understand that the ATO sees the involvement of agents as a way of securing compliance by taxpayers. It also makes it clear that the agent's own compliance is important and non-compliance might lead to prosecution and to an investigation by the Board as to whether the agent has breached the Code. It is registered tax agents who "... are vital in influencing voluntary compliance ..." and whose "... assistance and active support" is sought "... to ensure the integrity of the tax system." This message was tied in with the other, less than subtle, indication that departures from compliance norms on the part of the agent's clients will result in checks not only of the clients but also of the tax agent's practice. It is interesting to note that this part of the letter was removed in the 2013 version.

The information for new tax agents also includes a full explanation of the ATO's Risk Management approach and of the Promoter Penalties rules (in Div 290 TAA 1953). The ATO booklet that sets this out is *Guide for tax intermediaries: Good governance and promoter penalty laws*.<sup>105</sup> The tenor of the Commissioner of Taxation's foreword

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<sup>104</sup> Introductory letter at <http://www.ato.gov.au/taxprofessionals/content.aspx?doc=/content/20323.htm&mnu=43362&mfp=001/005> (accessed 1 March 2012) An updated letter, with the offending sentence removed is at <http://www.ato.gov.au/Tax-professionals/Tax-agents/In-detail/New-agents/Tax-agent-induction-package/> (accessed 19 August 2013).

<sup>105</sup> Commonwealth Government (2011) *Guide for tax intermediaries-Good governance and promoter penalty laws*.

sets the tone of the publication. Mr D’Ascenzo (the Commissioner at the time) explained in that foreword that

We are increasing our focus on tax advisers whose behaviours show a propensity to develop or encourage participation in tax exploitation schemes by clients.

As tax advisers, you not only need to be aware of the risks to your clients of participating in tax exploitation schemes but also the risks to yourself. Better practice would counsel the existence of internal checks and balances within your firms or companies to ensure you and your colleagues are operating within the law.

As well as potentially higher scrutiny for your clients, there have been a number of recent changes to the law where action can be taken against advisers who promote tax exploitation arrangements.<sup>106</sup>

The foreword continues to explain that the penalties under the promoter penalties rules can be very high indeed – as much as twice the fee received in respect of the scheme or \$2.75m, whichever is the greater. It also warns that there may be consequences for the tax agent under the TASA or prosecution.

... where we find evidence that tax practitioners are engaging in high risk activities that are not lawful or are not acting honestly in advising clients about aggressive tax planning arrangements, they will be referred to the Tax Practitioners Board for appropriate sanctions.

It is also possible to prosecute tax advisers who give false or misleading information to clients about the tax benefits arising from participation in tax exploitation arrangements, or whose conduct facilitates involvement of their clients in fraud or evasion.<sup>107</sup>

The foreword is factually correct, but it is interesting to note how the reference to the Board is open to an interpretation that it would not be expected to investigate and come to its own conclusion – it would simply impose “appropriate sanctions”.

The Guide describes and sets out in the form of a figure how the ATO compliance model identifies risks within the Promoter Penalty environment and addresses these risks in an appropriate manner. Tax agents engaged in more serious ‘Aggressive Tax Planning’ face a higher risk of ATO scrutiny and intervention.<sup>108</sup>

The Promoter Penalty regime and the full contents of the Guide are of interest and significance to tax agents. It is a means to make it not worth their while for tax practitioners to promote schemes that the ATO would regard as Aggressive Tax Planning. In simple terms, the effect of the regime is that an agent (or any entity) may not engage in conduct that results in its being a promoter of a tax exploitation scheme<sup>109</sup> and an agent may not conduct itself in such a way that results in a scheme being promoted on the basis of a product ruling being implemented in a way that is

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<sup>106</sup> Id, page i.

<sup>107</sup> Id.

<sup>108</sup> The relevant figure can be found at page 4 of Commonwealth Government (2011) *Guide for tax intermediaries-Good governance and promoter penalty laws*.

<sup>109</sup> Section 290-50(1) Schedule 1, *Tax Administration Act 1953*.



materially different from the way described in the product ruling.<sup>110</sup> Some discussion of these concepts can be found in a recent case.<sup>111</sup>

## 9. TAX AGENTS AND THE ATO'S RISK DIFFERENTIATION FRAMEWORK

The previous description of the ATO's approach to 'Aggressive Tax Planning' alluded to a differentiation framework used by the ATO to identify and scrutinize taxpayers they regard as of higher risk. Factors that are relevant in determining the risk posed by a particular taxpayer are the taxpayer's compliance history and the processes they have in place for managing compliance risk. It appears that included within the purview of these factors is the identity of the tax agent employed by the taxpayer.<sup>112</sup> Thus, the agent becomes part of the mix of factors taken into account by the ATO in adopting a particular compliance stance in relation to a taxpayer. The same factors are used in the ATO's *Risk Differentiation Framework Fact Sheet for Large Businesses*.<sup>113</sup>

It is not clear whether the tax agent's compliance standing in the eyes of the ATO is always revealed to the taxpayer as part of the explanation of what risk rating the taxpayer has been allocated by the ATO. That such conversations take place seems likely<sup>114</sup> in light of the fact that the ATO announced through its communications with large business that their risk categorisation is something about which the Commissioner will both write to them and meet to discuss with senior management of the very largest businesses.<sup>115</sup>

It is also unclear whether the tax agent will routinely be present at such a meeting or will have other notice of the risk rating that has been allocated to their clients or, indeed, that which has been allocated to them as tax agent. As such a rating, especially a rating that may impact on their clients, concerns their reputation and livelihood, it would be desirable and fair for the tax agent to be aware what impact its own rating has on the affairs of its clients — and if the rating seems wrong it seems it would also be fair to be able to challenge it.

Minutes of the (North Queensland) Regional Tax Practitioner Working Group (RTPWG) record the reaction of some of the members of that group to a presentation on the topic of risk profiling tax agents.<sup>116</sup> There is evidently a range of differing views on the risk profiling process. Some members saw the positive in the fact that one tax agent was profiled as high risk and, thus, targeted for frequent audit of its clients was beneficial to tax agents with a low risk rating. Others questioned crude

<sup>110</sup> Section 290-50(2) Schedule 1, *Tax Administration Act* 1953.

<sup>111</sup> See, *FCT v Ludekens & Anor* [2013] FCA 142; [2013] FCAFC 100; and [2014] HCA Trans 86.

<sup>112</sup> See, Craig Jackson, (2012) "Managing the ATO's perception of you in the new tax risk differentiation framework world", Presentation to The Tax Institute (NSW) 23/2/12.

<sup>113</sup> Commonwealth Government (2011) *Fact sheet for large business taxpayers Business — The risk differentiation framework*.

<sup>114</sup> Anecdotally, this has occurred on at least one occasion.

<sup>115</sup> See, ATO Website for Business taxpayers "Writing to you about our view" at <http://www.ato.gov.au/Business/Large-business/In-detail/Risk-Differentiation-Framework/Writing-to-you-about-our-view/> (accessed 19 August 2013).

<sup>116</sup> See, *Nth QLD RTPWG minutes*, (October 2011) Item 5 - Profiling Registered Agents to Support Differentiation accessible at [http://www.ato.gov.au/Tax-professionals/Tax-practitioner-consultation/In-detail/Regional-Tax-Practitioner-Working-Groups/North-QLD/Nth-QLD-RTPWG-minutes,-October-2011/?default=&page=7#5.\\_Profiling\\_Registered\\_Agents\\_to\\_Support\\_Differentiation](http://www.ato.gov.au/Tax-professionals/Tax-practitioner-consultation/In-detail/Regional-Tax-Practitioner-Working-Groups/North-QLD/Nth-QLD-RTPWG-minutes,-October-2011/?default=&page=7#5._Profiling_Registered_Agents_to_Support_Differentiation) (accessed 19 August 2013).

measures of risk such as the mere presence of an agent's name on a list of addressees advised of a possible tax scheme to which they may care to introduce clients. The argument raised was that the presence of their name on the list might indicate their efforts to gather intelligence about inappropriate tax schemes rather than it being evidence of their propensity to actually participate in them. Once again, it seems that if an agent is to be rated under risk profiling, adequate opportunities to challenge the outcome of the profiling exercise ought also to be put in place.

The risk profiling exercise is being prosecuted with vigour by the ATO as evidenced by a news item which suggested that a 'hit list' of a thousand tax agents and their clients had been targeted for audit by the ATO based on their risk profile.<sup>117</sup> This announcement appears to have been a reference to the New South Wales (NSW) RTPWG meeting in October 2011.<sup>118</sup>

The risk profiling process and the inclusion of tax agents in it has many implications in that the more sophisticated it becomes, the better will be the outcome for the ATO in collections and in the integrity of the tax system, to the benefit of society. However, the usual safeguards associated with the rule of law such as the ability to challenge an outcome that is detrimental to one's reputation and means of earning a living ought to be observed. That this opportunity to challenge a ranking seems to be in place is suggested by the minutes, referred to above of the NSW RTPWG<sup>119</sup> which assure registered agents that the ATO will explain how and why agents have been rated as they have been, will empower agents to understand the ATO's view of them and what the agent can do to change their rating, and that it will listen to feedback so as to improve and refine its differentiation approach.

It is hoped that the use in these minutes of the terms such as 'empower', 'based in evidence', 'explain what they can do to change', 'encourage and listen to feedback', imply a right to be heard and to contest an incorrect risk rating under a fair process.

## 10. REPORTABLE TAX POSITIONS AND THE ROLE OF TAX AGENTS

In addition to the tightening of the role of the tax agent and ensuring the tax agent is essentially 'on the same side' as the ATO in its interaction with the tax system, a further constraint aimed at controlling avoidance has come to light. This is the Reportable Tax Position (RTP) regime. This is not strictly a regime that controls registered tax agents but it does involve them, as will now be explained.

The RTP initiative requires selected taxpayers to report and disclose to the ATO, by means of a schedule, "their most contestable and material tax positions".<sup>120</sup> The requirement that this schedule be lodged seems to be an administrative rather than

<sup>117</sup> See, 17 Feb 2012 *Adelaide Advertiser* "Cashed-up tradies face tax heat" at <http://www.adelaidenow.com.au/business/tradies-face-tax-heat-crackdown-aims-to-catch-dodgy-accountants/story-e6frede3-1226273336711> (accessed 2 March 2012).

<sup>118</sup> See, *NSW RTPWG minutes*, (October 2011) Item 5 – Registered agents differentiation project – accessible at [http://www.ato.gov.au/Tax-professionals/Tax-practitioner-consultation/In-detail/Regional-Tax-Practitioner-Working-Groups/NSW/NSW-RTPWG-minutes,-October-2011/?default=&page=7#5.\\_Registered\\_agents\\_differentiation\\_project](http://www.ato.gov.au/Tax-professionals/Tax-practitioner-consultation/In-detail/Regional-Tax-Practitioner-Working-Groups/NSW/NSW-RTPWG-minutes,-October-2011/?default=&page=7#5._Registered_agents_differentiation_project) (accessed 19 August 2013).

<sup>119</sup> Id.

<sup>120</sup> See, <https://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Large-business-and-tax-compliance-publication/?amp=&page=35>.

substantive measure<sup>121</sup> targeted at large businesses.<sup>122</sup> The involvement of the tax agent in this administrative measure to identify in advance what the contentious issues are in the ATO's relationship with targeted taxpayers may not be obvious at first. It is submitted, however, that the definition of a "reportable tax position" is one that will often require tax agents (as well as in-house tax counsel and other advisers) to exercise professional judgment. Thus, their advice becomes a crucial aspect of the operation of the RTP regime, and so they become an important part of its operation. The particular aspect of the definition that prompts this suggestion is the inclusion in RTP of "...a material position that is about as likely to be correct as incorrect or less likely to be correct than incorrect ...".<sup>123</sup> This can place the tax agent at the centre of the need to submit a schedule. One wonders what data is gathered as to the frequency with which certain tax agent's names are found, or not found, linked with clients making RTP disclosures. Dabner's research seems to suggest that there will be reluctance on the part of tax agents to reveal some tax positions,<sup>124</sup> although this regime will make it increasingly difficult for tax agents or BAS agents not to do so.

## 11. CONCLUSION

This article has noted that the Australian legislature has apparently heeded the evidence in the compliance literature, which demonstrates the critical role in tax compliance that is played by tax intermediaries.<sup>125</sup> There are good reasons for the ATO, in return for fully sanctioned participation in the tax agent system, to attempt to align tax agents' interests with its own.

This appears to have been achieved in most emphatic fashion in Australia. At least insofar as the statutory regime is concerned, the Australian rules have reached a point where tax agents in Australia have to consider a range of matters in addition to the instructions of the client. They have a role in securing compliance of the taxpayer with tax law and there are suggestions that the ATO would seek to influence how this is done. This arises from the expectation that tax agents and BAS agents will verify the information the taxpayer provides to them. It also arises from the professional risk they face in representing non-compliant taxpayers. The outcome is quite understandable and highly desirable from the point of view of the public purse. There remain some questions as to what controls on the arrangements the courts may determine to impose under rule of law principles (such as the right to know that an adverse finding has been made against one, and the reasons for it, the right to challenge an outcome that is detrimental to one's reputation and professional income etc.), but provided taxpayers and agents have an opportunity to have their treatment by the ATO reviewed by the courts, it should be that such concerns can be assuaged. More interesting, and perhaps more threatening, is the suggestion in Dabner's interviews with tax professionals in the UK that tightening the controls on them may

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<sup>121</sup> See, (2011) *International Tax Review*, "Australia deals with new methods of resolution" 12 September 2011.

<sup>122</sup> See, *Reportable tax position schedule*, at <http://www.ato.gov.au/Business/Large-business/In-detail/Reportable-tax-positions/Reportable-tax-position-schedule/>. At the time of writing reports were that 56 large taxpayers were required to lodge schedules in 2012.

<sup>123</sup> <http://www.ato.gov.au/Forms/Guide-to-reportable-tax-positions-2013/?page=7#Definitions> (accessed January 2014).

<sup>124</sup> See, n 122 above and reference to Dabner n 3 above, page 536.

<sup>125</sup> See, the sources at n 14 above.

damage the relationship between tax professionals and HMRC.<sup>126</sup> One wonders whether, insofar as the UK experience is relevant to Australia tightening control on tax agents and BAS agents in Australia might undermine the relationship between them and the ATO. Time will tell.

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<sup>126</sup> Dabner n 3 above, page 546. Dabner referred to “The recent HMRC initiatives, referred to above, viewed by the profession as an attempt to regulate it and push down further responsibilities from the administrator to the profession” as a factor that might damage the relationship between the HMRC and tax professionals.

## 12. APPENDIX

### Code of Professional Conduct for Tax Agents/BAS Agents<sup>127</sup>

#### *Honesty and integrity*

- (1) You must act honestly and with integrity.
- (2) You must comply with the taxation laws in the conduct of your personal affairs.
- (3) If:
  - you receive money or other property from or on behalf of a client; and
  - you hold the money or other property on trust;
  - you must account to your client for the money or other property.

#### *Independence*

- (4) You must act lawfully in the best interests of your client.
- (5) You must have in place adequate arrangements for the management of conflicts of interest that may arise in relation to the activities that you undertake in the capacity of a registered tax agent or BAS agent.

#### *Confidentiality*

- (6) Unless you have a legal duty to do so, you must not disclose any information relating to a client's affairs to a third party without your client's permission.

#### *Competence*

- (7) You must ensure that a tax agent service that you provide, or that is provided on your behalf, is provided competently.
- (8) You must maintain knowledge and skills relevant to the tax agent services that you provide.
- (9) You must take reasonable care in ascertaining a client's state of affairs, to the extent that ascertaining the state of those affairs is relevant to a statement you are making or a thing you are doing on behalf of a client.
- (10) You must take reasonable care to ensure that taxation laws are applied correctly to the circumstances in relation to which you are providing advice to a client.

#### *Other responsibilities*

- (11) You must not knowingly obstruct the proper administration of the taxation laws.
- (12) You must advise your client of the client's rights and obligations under the taxation laws that are materially related to the tax agent services you provide.
- (13) You must maintain the professional indemnity insurance that the Board requires you to maintain.
- (14) You must respond to requests and directions from the Board in a timely, responsible and reasonable manner.

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<sup>127</sup> See s30–10 TASA.

# Corporate profiling of tax-malfeasance: A theoretical and empirical assessment of tax-audited Australian firms

Grant Richardson<sup>1</sup>, Grantley Taylor<sup>2</sup>, and Christopher S. Wright<sup>3</sup>

## ***Abstract***

Tax avoidance and tax evasion represent serious breaches of corporate social responsibility which threaten a country's revenue base. This study gathers these related issues under the umbrella term *tax malfeasance*. Using the annual reports of 203 firms over the 2006–2009 period, we find that firms that were audited by the Australian Taxation Office tend to exhibit values that significantly differed from those of non-audited firms, and those differences were linked to tax malfeasance via notions in Cressey's (1950) *fraud triangle*. Our results show that firms who are prone to engage in tax malfeasance can be profiled and that such a profile may be a useful means to fairly and cost-effectively target tax audits.

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<sup>1</sup> School of Accounting and Finance, The Business School, University of Adelaide, 10 Pulteney Street Adelaide, South Australia, 5005 AUSTRALIA, Tel: +61-8-83130582, Fax: +61-8-82234782, Email: grant.richardson@adelaide.edu.au

<sup>2</sup> School of Accounting, Curtin Business School, Curtin University; GPO Box U1987 Perth, Western Australia, 6845, AUSTRALIA, Tel: +61-8-92663377, Fax: +61-8-92667196, Email: Grantley.taylor@cbs.curtin.edu.au

<sup>3</sup> Faculty of Higher Education, Holmes Institute 85 Spring Street, Melbourne, Victoria, 3000, AUSTRALIA, Tel: +61-3-96622055, Email: melbourne@holmes.edu.au

## 1. INTRODUCTION

Over the past decade, an explosion “... in the variety and volume of literature on corporate social responsibility (CSR) ...” has included many assessments of CSR breaches (Sikka, 2010, p.153), including efforts to aggressively minimize corporate-tax payments (Lanis and Richardson, 2012; Hasseldine and Morris, 2013). Much of this expansive literature succeeded in its intent to empirically verify the presence of corporate social malfeasance (CSM), in particular with respect to corporate failures to meet tax obligations (such as tax malfeasance)<sup>4</sup>. This study transposes processes that are commonly highlighted in the extant literature by empirically building a corporate profile of how firms that are perceived as being likely to engage in tax malfeasance (as evidenced by tax audit/review) differ from the majority of firms who continually meet their CSR obligations.

Under a CSR mandate, firms are expected to contribute a fair share of their profits to fund the governance, infrastructure and social goods/services of the society in which they operate and/or to offset their use of the common resources being funded (policing, legal and security, physical infrastructure (for example roads, communications and power), education, research, hospitals, etc). While it is acceptable for taxpayers to use *tax planning* to work within tax laws, rules and procedures to ensure reasonable tax bills, society frowns on overly *aggressive tax behavior*. The *aggressive tax behaviors* of tax avoidance and evasion are grouped into tax malfeasance, because both wrongfully deprive “... government of revenues needed for the provision of infrastructures, and for public services and public utilities” (Otusanya, 2011, p.316), with the former considered a social wrong and the latter a criminal act.

A key premise in this study is that behaviors and acts that lead to tax malfeasance are closely linked with those that lead to civil and criminal fraud.<sup>5</sup> Therefore, fraud-prevention models like Cressey’s (1950) *Fraud Triangle* can be adapted so as to provide insight into the motivators/pressure, thinking/rationalization and choices/opportunities of those firms who commit tax malfeasance. The insights were used to structure and guide our enquiry as to how the antecedent processes of tax malfeasance tend to alter the attributes of firms with a propensity to engage in tax malfeasance from patterns that are likely to be common in those who faithfully discharge their tax obligations. The Cressey (1950) *Fraud Triangle* attribute structure (*pressure, rationalization and opportunity*) is unlikely to be as meaningful in the latter firms as it is in the former. Thus, the reviewed attributes were gathered in terms of

<sup>4</sup> Malfeasance is a legal term (see for example West’s Encyclopaedia of American Law, 2008; Nolo’s Plain-English Law Dictionary, 2009) encompassing acts that are seen in civil courts as wrongful and/or in criminal courts as criminal. Tax malfeasance encompasses tax avoidance (as a social wrong) and tax evasion (as a criminal act). In civil actions, misfeasance and nonfeasance are terms related to malfeasance, but both suggest less malice of intent and nonfeasance is a failure to perform a contracted or socially expected act or action.

<sup>5</sup> Fraud is a nebulous term with many overlapping definitions (for example West’s Encyclopaedia of American Law, 2008; Nolo’s Plain-English Law Dictionary, 2009; Merriam-Webster Dictionary, 2013; Oxford Dictionary, 2013) which can be denoted as a deceit, deception, and/or breach of trust designed to gain the perpetrator (or related person or group) a wrongful advantage and/or to induce a wrongful disadvantage on another party (for example person or firm). Fraud is always a social wrong (such as a civil law violation or other bad act) and its more virulent forms (based on intent and level of harm) tend to be legislated as lesser or major criminal offenses (such as a misdemeanour or a felony).

more neutral categories (such as general, transfer pricing, perceived risk and operational features), and Cressey's (1950) *Fraud Triangle* was used to develop insight into the import of differences in the reviewed attributes.

Based on the qualitative analysis, a sample of 203 firms was drawn from Australia's top 300 publicly-listed firms over the 2006–09 period. Quantitative analysis of the sampled firms found that those who had been audited for tax malfeasance by the Australian Taxation Office (ATO) displayed similar values for key attributes, and that the values for those attributes tended to be significantly different for the non-audit firms. For Cressey's (1950) *Fraud Triangle*, the reviewed attributes involved mostly opportunity, with some involving pressure and only one that involved rationalization. Further, an interesting (inferred) qualitative finding, given the extensive command-control-and-reporting systems (CCRS) used to identify and prevent agents and employees from acting in ways that put the firm's reputation and/or its wealth at risk, was that individuals or groups who perpetrate tax malfeasance must be in a position to exploit weaknesses in the firm's CCRS or must have the authority, power, and control to create and sustain such weaknesses.<sup>6</sup> The sustained presence of CCRS weaknesses was found to form a large part of the attribute profile of tax-audited firms in our sample.

The analysis carried out in this study shows that developing a corporate profile that is strongly suggestive of tax malfeasance is feasible and potentially quite useful. Such profiles should help tax authorities (for example the ATO) to fairly and cost-effectively target tax audits. Further, given that many of the profile attributes are pathways to facilitate the camouflage and commission of tax malfeasance, another benefit of revealing them as potential audit triggers could be to make tax malfeasance more difficult and risky for corporate-tax malefactors. While most of the analysis results are consistent with theory and literature-based expectations, there were two surprising departures. Specifically, tax-audited firms appear to have relatively high effective tax rates (ETRs) and tend to use big-4 auditors more extensively than non-audited firms. The first unexpected analysis outcome suggests that in terms of Cressey's (1950) *Fraud Triangle*, ETRs may be more of a *pressure* to engage in tax malfeasance than an *outcome*. The second unexpected analysis outcome is consistent with the James Hardie Group (JHG) review finding (see below) that firms who engage in CSM tend to so convolute their affairs that 'big-4' auditor involvement becomes a necessity. Further, the finding that the external auditor firms of tax-audited firms derive a significantly greater amount of non-audit fees from tax-related services than those of non-tax-audited firms adds to worries over auditor independence being compromised. Again, this outcome can be explained by the self-inflicted greater tax complexities of the tax-audited firms. When considered as a whole, these findings suggest that (for the sampled tax-audited firms and the JHG) a propensity for tax malfeasance appears to be a dubious strategy (for example, gross gains are often more than offset by significantly increased complexity leading to higher costs, risks and distractions from other key strategic and operating concerns).

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<sup>6</sup> However, tax authorities tend to hold firms accountable for any tax malfeasance committed in their name and rarely (if ever) prosecute the agents or employees who physically perpetrated the tax malfeasance.



The rest of this paper is organized as follows. Section 2 considers how Cressey's (1950) *Fraud Triangle* adds insight to corporate tax malfeasance. Section 3 provides an overview of the JHG to show how tax malfeasance can arise as an entanglement of other CSM. Section 4 reviews the evidence of tax malfeasance. Section 5 discusses the research scope and hypotheses. Section 6 summarizes the research design. Section 7 reports the findings, and Section 8 concludes.

## 2. TAX MALFEASANCE INSIGHT FROM CRESSEY'S (1950) FRAUD TRIANGLE

Cressey's (1950) *Fraud Triangle* has for over 60 years and with few changes, helped auditors comprehend and illustrate the driving factors that can encourage and allow trusted employees of the firm to engage in fraud (see for example Wolfe and Hermanson, 2004; Kassem and Higsonm, 2012)<sup>7</sup>. Indeed, Cressey's (1950) *Fraud Triangle* has been linked to financial statement fraud by numerous accounting researchers (see for example Wells, 1997; Montgomery, Beasley, Menelaides & Palmrose, 2002; Coenen, 2007; Skousen, Smith & Wright, 2008).

In Figure 1, we adapt Cressey's (1950) *Fraud Triangle* from its original inflexible triangle to a meshed set of "progressing gears" where removal of any of the driving gears stops the process and the:

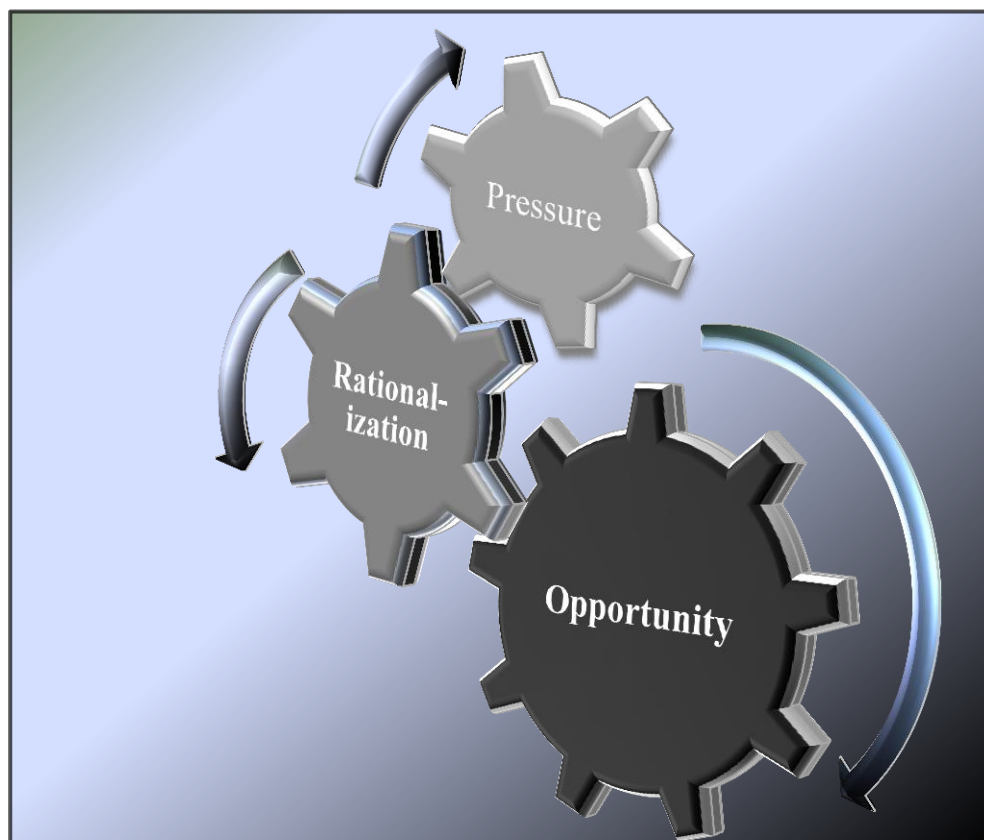
*Pressure Gear* (for example debts, a desire for material wealth or status, and/or employment performance pressure) can initiate the process, then;

*Rationalization Gear* can erode/discount moral qualms about the action, concern over its effects on others, and/or fear of the risks/consequences of being caught; and then

*Opportunity Gear* reflects a perpetrator's search for, and/or creation of, opportunities to commit fraud/malfeasance.

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<sup>7</sup> It should be noted that Cressey's (1950) *Fraud Triangle* was incorporated into auditing standards by the American Institute of Certified Accountants (AICPA) in its Statement of Auditing Standards No. (SAS) 99: Consideration of Fraud in a Financial Statement Audit (AICPA, 2002).

**Figure 1: Antecedent drivers/enablers of fraud and corporate tax malfeasance**

Source: Adapted from Cressey's (1950) *Fraud Triangle*.

While Cressey's (1950) *Fraud Triangle* and much of the related literature (implicitly) focus on individuals defrauding employers or breaching trust with clients, Figure 1 is also applicable to acts of CSM. However, individuals perpetrating CSM tend to have great authority, power and control within their firms as evidenced by their capacity to over-ride their firm's command-control-and-reporting systems (CCRS) that are (or should be) designed to discourage and/or highlight any defalcations and other malfeasance.

In terms of Cressey's (1950) *Fraud Triangle*, pressure to engage in bad acts can arise from performance-linked pay (a status-based need for their firms to perform well, etc.) and rationalization of tax malfeasance becomes easier if, instead of sharing society's moral outrage toward tax malfeasance (in particular, tax avoidance), senior management views tax *as a cost of business* and believe that (as with other costs) their duty is to minimize it<sup>8</sup>. Further, the opportunity to successfully commit and hide corporate tax malfeasance usually requires that the perpetrators: significantly degrade the relevant aspects of their firm's CCRS; instigate a culture of active connivance and/or passive acquiescence among the accounting staff (where possible); and co-opt,

<sup>8</sup> Corporate rationalization of CSM and other bad acts often draws from a variant of Friedman's (1970) infamous proposition that: "The [only] social responsibility of business is to increase its profits."

corrupt and/or confuse the relevant internal and external auditors, regulators and tax authorities (see, Sikka and Hampton, 2005; Sikka, 2013).

As noted previously, unlike perpetrators of CSM, perpetrators of frauds against employers or clients often lack the requisite influence to create and/or enhance opportunities for fraud and must, therefore, seek out and exploit flaws in the CCRS. Thus, in cases of fraud, it is sensible for auditors to examine for evidence of pressure (for example gambling debts, living beyond ones visible means, addiction, etc.) and to look for breaches of the CCRS. However, that scope of audit review (while necessary) is insufficient for tax malfeasance and other CSM audits. Specifically, auditors need to recognize that CSM perpetrators often have the requisite authority, power and control to over-ride or otherwise subvert their firm's CCRS. Hence, auditors seeking to provide assurance of the absence of CSM need to greatly expand their audit scope to include degradation of the target firm's CCRS and culture and a capacity to influence, threaten or suborn their firm's internal auditors and/or (supposedly independent) external reviewers. While it can be argued that some executives engaged in tax malfeasance may feel that they are not committing a social wrong, they are aware of punishment and are likely to seek to obscure any acts of tax malfeasance.

### 3. OVERVIEW OF THE JAMES HARDIE GROUP

A library of articles, books and blogs have been written on the extensive CSR failures of the James Hardie Group (JHG). Fortunately, an overview of this firm is more appropriate to the needs of our study than a definitive and exhaustive case study. The following overview of the JHG strongly suggests that while it is unclear whether the JHG intended to commit tax malfeasance, the complexities, intrigue, and disjointedness of efforts to evade its legal and CSR duties to people harmed by its asbestos-based products inevitably led it into actions that (from a business rationale) were dubious and that the tax authorities of several nations interpreted as being tax malfeasance.

During the 20<sup>th</sup> century, the collection of firms that are now called the JHG had the great misfortune of becoming the preeminent supplier of asbestos-based fiber board and many other asbestos-based products. That misfortune was intensified and compounded into CSM when the JHG chose to continue producing, promoting and supplying asbestos-based products long after it was readily apparent that processed asbestos was a highly toxic product that (even when produced and/or used as directed) was likely to injure, profoundly disable and eventually kill those who are exposed to it or its dust. The decision to continue its asbestos-based-product lines further enmired the JHG in asbestos-based liability, which threatened the survival of the entire group, and (in terms of Cressey's (1950) *Fraud Triangle*) added pressure to rationalize and commit further bad acts. Thus, the original asbestos-driven CSM of the JHG was potentiated and compounded by devious efforts to disassociate JHG from and/or otherwise evade its asbestos-related liabilities estimated at AUD\$1.54 billion (Jackson, 2004). Initial efforts (1995–2000) to separate the JHG group assets from its asbestos-related liabilities were limited to asset-stripping its subsidiaries who were directly involved in promoting and selling asbestos-based products (ACTU, 2007). After finding that the Australian legal system was not satisfied with the AUD\$293 million of net value left in the asset-stripped subsidiaries, the JHG moved its operations and AUD\$1.9 billion in assets to the Netherlands in 2001 and later (2010) underwent

another restructuring and move to Ireland to become an Irish *Societas Europea* company.

While this devious maneuvering enabled the JHG to evade much of its CSR to those harmed by its asbestos-based products, it also ensnared the JHG and its principals in an ever-expanding quagmire of legal and tax complications and difficulties. Specifically, seven JHG principals were found guilty of misleading the Australian Stock Exchange (ASX) as to the magnitude of JHG's asbestos-related liability and the future accessibility of asbestos-related claims to assets that were moved offshore from Australia in 2001 (Sky News, 2012). Furthermore, the asset transfers and corporate restructurings were so complex, oblique and obtuse that audits (by various tax agencies situated in different jurisdictions) found multiple tax errors and tax malfeasance in the structuring, timing and documentation of the related tax filings. These latter effects are of great interest to this study, along with how the JHG's cupidity led to evasion of its legal and social responsibilities and caused it to blunder into transactions that were seen as tax malfeasance.<sup>9</sup>

The asset-stripping, corporate restructuring, and moves to other jurisdictions enabled JHG to leverage tax concessions from the Australian Government in 2004 on any future income that it transferred to a voluntary compensation fund established as a charity by the JHG. In seeking to take advantage of this concession, a series of transactions between JHG firms were crafted to reduce withholding taxes payable in the U.S. by shifting wealth as dividends to Australia and then to transfer the resulting net after-tax wealth to an off-shore subsidiary in Malta.<sup>10</sup> However, the ATO Commissioner used GAAR provisions in the *Income Tax Assessment Act 1936* (C<sup>th</sup>) to reorganize the transaction to increase the JHG taxable capital gains by AUD\$478.2 million and added another AUD\$387.7 million in taxes, penalties and interest. An appeal of that decision, seeking to reduce the amount payable by AUD\$240 million was refused and the assessed taxes, penalties and interest were up-held.<sup>11</sup> The JHG corporate reorganization and move to Ireland also created tax issues with the U.S. Internal Revenue Service (IRS). Specifically, in June 2008 the IRS issued a *Notice of Proposed Adjustment* that stated that JHG did not qualify for the limitations of benefit provision under the amended United States–Netherlands Income Tax Treaty for 2008 and subsequent years.<sup>12</sup> In connection with the JHG proposal to re-domicile its corporate base from the Netherlands to Ireland, it incurred a tax liability that arose from a capital gain on the transfer of its intellectual property from the Netherlands to a

<sup>9</sup> This type of manoeuvring and its extent are neither peculiar to the JHG nor even uncommon. Desai and Hines (2002) argue that firms are able to accentuate their international corporate tax avoidance activities of thin capitalization, transfer pricing and income shifting through the use of tax haven incorporated entities.

<sup>10</sup> Specifically, the firms involved were James Hardie Industries Ltd., James Hardie (Holdings) Inc and RCI Pty Ltd.

<sup>11</sup> *RCI Pty Ltd v FC of T* 2010 ATC 20–207. The key issue was whether the provisions of Part IVA, specifically section 177F(1)(a), entitled the Commissioner to make the determination, as well as a further determination under section 177F(2) that the tax benefit shall be deemed to be included in the assessable income of RCI as a net capital gain by virtue of section 102–5 of the Income Tax Assessment Act 1997 (Cth).

<sup>12</sup> Under the limitations of benefit provision, a 5% dividend withholding tax is applicable and no interest or royalty withholding taxes are applied to payments made by U.S. subsidiaries to Dutch subsidiaries. Under the amended U.S.–Netherlands Income Tax Treaty, 30% U.S. withholding taxes could be applicable.

newly-formed James Hardie entity (James Hardie Technologies Ltd.) located in Bermuda (a tax haven) and tax resident in the Republic of Ireland and the exit from the Dutch Financial Risk Reserve Regime. The JHG was subject to considerable uncertainty with regards to the quantum of tax liabilities that should be recognized from these transactions. The JHG recorded tax adjustments of USD\$380.7M in the 2011 fiscal year, reflecting a USD\$32.6M tax charge arising from corporate restructure and a non-cash expense of USD\$345.2M following the dismissal of RCI Pty Ltd.'s appeal of the 1999 disputed amended tax assessment (James Hardie Annual Report, 2011).

The JHG case study is important to this study in that it shows that when large firms engage in major CSM, they often run afoul of tax issues and/or may compound their CSM with efforts to enhance their gains through tax malfeasance. The JHG case is typical of firms who are engaged in complex CSM. Specifically, the process involves the interleaving of several key elements: tax havens, funds transfers, debt transfer, withholding taxes and international re-structuring. In this study, we propose, test and empirically show that several important attributes of publicly-listed firms are indicative of behaviors that tax authorities will want to audit. The JHG case suggests that even if the primary incentive by a firm is a CSM other than tax malfeasance, tax malfeasance and/or misfeasance is almost inevitable as an element of such behaviors.<sup>13</sup>

## **4. EVIDENCE OF TAX MALFEASANCE**

### **4.1 The ATO's perspective on tax malfeasance**

In recent years, publicly-listed Australian firms have come under increasing scrutiny by the ATO and the tax authorities of other nations. The ATO (2010) is emphasizing, in various tax-compliance programs, that there is a significant tax-revenue-erosion risk by reason of the timing and/or structuring of international dealings by very large firms (such as those with more than AUD\$100M in market capitalization), 68 per cent of which have offshore affiliates, with some incorporated in tax havens. These observations suggest that the ATO believes major Australian firms have a substantial potential for tax malfeasance and that some engage in that proficiency, regularly and persistently. While unconscionable at any time, the behaviors that the ATO is worried about are particularly pernicious during and shortly after the global financial crisis when most governments experienced significant declines in tax revenue, combined with a substantial rise in costs and commitments to their constituents.<sup>14</sup>

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<sup>13</sup> See note 1; and misfeasance tends to be bad behavior that lacks the intent to harm that is present in malfeasance. However, the tax statutes of most developed countries put an onus on taxpayers to be aware of and obey tax laws. Thus, the ignorance of misfeasance is rarely an effective defense if indicted for tax malfeasance.

<sup>14</sup> Activities that spurred the tax reviews/audits in Australia included: income shifting, strategic debt placement, withholding taxes, R&D expenditure deductions, bad debt deductions, interest expense deductions and the use of tax havens (ATO, 2010).

## 4.2 Other commentaries on tax malfeasance

The following commentaries, among other things, highlight how the elements of Cressey's (1950) *Fraud Triangle* (as adapted for this study (see Figure 1 above) aptly illustrate the three drivers of tax malfeasance:

*Pressure* is described by Dhaliwal, Newberry and Weaver (2005) and Beattie, Goodacre and Thomson (2006) when they note that corporate tax payments can adversely affect a firm's financial position, financial performance, liquidity, operational results and cash flows. And that, in an effort to optimize these attributes, firms may organize specific arrangements, transactions or events to avoid or evade the corporate taxes that would otherwise be payable;<sup>15</sup>

*Rationalization* can be seen in the Minnick and Noga (2010) observation that, at an extreme, tax malfeasance activities may be viewed by top management as an integral part of normal business processes that are justified by the objective of enhancing corporate profitability and shareholder returns (see also, Friedman, 1970); and

*Opportunity* creation is clear in the Desai and Dharmapala's (2006; 2009) observation that international-tax malfeasance activities typically involve a transfer of income and debt among jurisdictions, in an attempt to obtain a benefit by *arbitraging income recognition* across variable tax rates.<sup>16</sup>

## 5. RESEARCH SCOPE AND STATEMENT OF HYPOTHESES

Our study seeks to determine whether firms that tend to engage in tax malfeasance can be profiled, based on key attributes. Such corporate profiling should be of great value to tax authorities as a means to fairly and more cost-effectively target their audit effort. In determining whether such a profile can be developed and likely to be useful, we searched for key differences in general-tax, transfer-pricing, corporate-governance, external-auditor use-and-independence and operational attributes of publicly-listed Australian firms. Knowing those differences will enhance our understanding of how specific attributes are associated with corporate tax malfeasance and may suggest their role in facilitating that activity. Attributes identified with tax malfeasance were also related to the JHG, which in many decades of engagement in serious CSM<sup>17</sup>, also

<sup>15</sup> Dyreng et al. (2008) found that successful long-run tax-malfeasance firms tend to be associated with significantly higher leverage. Higher leverage adds to corporate pressure (via higher interest payments and expenses) and can encourage recklessness by corporate managers via reduced financial consequences to shareholders (if the firm is bankrupted by back-taxes, penalties, and interest) by shifting much of the risk (but little or no benefits) to creditors.

<sup>16</sup> It is also likely that firm size is a powerful multiplier in corporate tax malfeasance. Rego (2003) claims that larger firms can achieve economies of scale with tax planning and have the resources and incentives to reduce corporate income taxes. Hanlon, Mills, & Slemrod (2005) also find that larger firms tend to have greater tax deficiencies relative to their actual tax liability.

<sup>17</sup> For example, selling asbestos-based products long after it became apparent that asbestos caused chronic injury leading to debility and death, seeking to isolate the majority of its assets from the legitimate claims of those injured by its products, lying to the ASX, moving its assets offshore to evade litigation, etc.

attracted many years of scrutiny by the ATO and other tax agencies around the world. What we are seeking in this study are corporate attributes that individually and/or in combination are a likely indicator of corporate tax malfeasance, even if those actions are ancillary or adjunct to other CSM. The general null hypothesis of: “*the absence of statistically-significant differences between tax-audited and non-tax-audited firms*” reflects the stated intent of this study and is tested through the examination of four subsidiary null hypotheses, asserting: *the absence of statistically-significant differences between tax-audited and non-tax-audited firms*, in terms of their:

H<sub>1</sub>: general tax attributes;

H<sub>2</sub>: transfer pricing attributes;

H<sub>3</sub>: perceived risk attributes; and

H<sub>4</sub>: operational features/attributes.

A concern of this study is the risk of biases arising in the sample selection and analysis, so this is addressed in the research design (see below). Specifically, sampled firms are selected so that the predilection for tax malfeasance of the sampled firms is isolated from irrelevant differences. Thus, the sampled firms should be reasonably similar in size and in the legal and business environments in which they operate. The next section discusses how these objectives are served by the design of the sampling process, the choice of variables and the empirical analysis.

## 6. RESEARCH DESIGN

The universe of firms analyzed in this study is drawn from the top 300 publicly-listed Australian firms, with exclusions designed to ensure a statistically valid sample. A four-year sample period was selected as part of a trade-off between longer periods yielding better statistics but greatly raising the risk of data fouling (for example due to time-based trends and/or survivorship bias). The years 2006–09 were chosen for the sample period because they are the most recent years of publicly available financial data at the time this study was carried out.

The first exclusion of firms ensured data continuity by eliminating firms that did not file annual financial reports continuously throughout 2006–09 and reduced the initial sample by 20 firms (such as those that reported for only part of the review period because they were newly incorporated, taken-over, merged with other firms, etc.). The second exclusion reduced the sample firms by 61 firms that were deemed to have little opportunity to engage in tax malfeasance because they are closely regulated.<sup>18</sup> The third exclusion removed 16 firms from the sample because they followed a different reporting standard (such as U.S. GAAP).

After the sample was finalized at 203 firms, the research methodology then involved splitting the sample firms into those that during 2006–09, were: (1) tax-audited; and (2) not-tax-audited. During the 2006–09 period of our study, the ATO (and other tax

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<sup>18</sup> The excluded firms consisted of: (1) 39 financial firms, (2) 11 insurance firms, and (3) 11 property partnership or trust entities.

authorities) audited the financial accounts of 30 firms to consider several issues as reported in Table 1. The most significant types of tax aggressiveness presented in Table 1 involve corporate restructuring (16.67%) and the deductibility of interest expenses (13.34%). Other important types of tax aggressiveness include asset disposals under capital gains tax, the deductibility of intellectual property, R&D expenses and tax losses, and the offshore income tax exemption (10%).

**Table 1: Types of tax aggressive activities pursued by firms in the sample**

Types of tax aggressiveness	Incidence	
	No. of firms	Frequency (%)
Corporate restructuring	5	16.67
Deductibility of interest expenses	4	13.34
Asset disposals – capital gains tax	3	10.00
Deductibility of intellectual property	3	10.00
Deductibility of R&D expenses	3	10.00
Deductibility of tax losses	3	10.00
Offshore income tax exemption	3	10.00
Claiming of capital gains tax losses	2	6.67
Acquisition of dividend franking credits	1	3.33
Deductibility of bad debts	1	3.33
Deductibility of concession fees	1	3.33
Deductibility of pre-contract work expenses	1	3.33
Totals	30	100.00%

It is worth noting that being the subject of audit/review activity by the ATO is not *per se* evidence of tax-malfeasance guilt. In fact, many (if not most) taxes do not meet the desired trait of being fully neutral (for example not affecting economic choice) and as a result, many corporate transactions and events have tax consequences with ensuing potential tax benefits/costs accruing to the choice of how to conduct an underlying transaction. While most tax authorities deem that there is no tax malfeasance if tax benefits result as part of an overall business objective. However, if the tax benefits are believed to arise from a scheme designed wholly (or mostly) to avoid income taxes, then an effort is made to apply general anti-avoidance regulations (for example in Australia, Part IVA of the *Income Tax Assessment Act 1936* (*C<sup>th</sup>*)).

Finally, selected data were hand-collected from the annual reports of the sample firms. The finalized sample of firms yielded 812 firm-year observations with approximately 14.78 per cent of the firm-year observations relating to firms who *were* tax audited or reviewed over the period.

## 7. DIFFERENCES BETWEEN TAX-AUDITED AND NON-TAX-AUDITED FIRMS

As mentioned previously, this study seeks to determine if tax-audited firms have *stand-out* attributes that distinguish them from non-tax audited firms. If such *stand-out* attributes can be determined, they should be of great value to tax authorities in planning who, what and when to audit for corporate tax malfeasance. Given that attributes tested in this study are very often pathways to facilitate the camouflage and



commission of corporate tax malfeasance, if they become generally known as audit triggers, revealing them could make the commission of corporate tax malfeasance more difficult and risky for corporate-tax malefactors. The following subsections are organized in terms of the subsidiary null hypotheses introduced in Section 5 of the paper (above).

The reviewed attributes are classified in our results (see Tables 2–5) in terms of Cressey's (1950) *Fraud Triangle* of: pressure (P), rationalization (R), or opportunity (O). It is interesting that one (3.8%) of the reviewed attributes is classified as *rationalization*, eight (30.8%) are classified as *pressure* and 17 (65.4%) are classified as *opportunity*. In fact, *rationalization* is rarely in itself a bad act, *pressure* is inducement to behave badly, but many have sufficient integrity 'to rise above it' and the *opportunity* to behave badly (for example the degrading of preventative controls) is usually intended to facilitate a bad act (such as by enabling it and/or evading punishment). Thus, it is not surprising that the reviewed attributes classified as rationalization/excuses are rare and those classified as opportunity/outcomes are quite common.

## 7.1 General tax attributes

ETRs are used as proxies of corporate tax avoidance because effective tax planning can reduce a firm's tax liability without necessarily reducing the accounting income reported in its financial statements (ATO, 2006; Rego, 2003; Richardson and Lanis, 2007). As noted previously, while tax planning is a socially accepted activity, both tax avoidance and tax evasion are considered to be tax malfeasance. Given that reduced ETRs are an expected key goal of tax malfeasance, low ETRs are likely to be present in firms engaged in effective corporate tax malfeasance, however, they may also be present (to a lesser degree) in firms not so engaged.

Analysis of 10 *general tax attributes* (including the one outlined above) found (see Table 2) that, vis-à-vis non-tax-audited firms, tax-audited firms have significantly higher: ETRs; carried-forward tax losses; negative adjustments to *prima facie* income tax (owing to lower tax rates applied to operations in overseas jurisdictions) and negative adjustments to *prima facie* income tax (relating to R&D expenditure); uncertainty in the estimation of tax liabilities; likelihood of having a subsidiary incorporated in an OECD (2006) listed tax haven; and chance of being subject to withholding taxes.<sup>19</sup> Based on these results, the subsidiary null hypothesis  $H_1$  is rejected and the alternative (of statistically significant differences in *general tax attributes*, between tax-audited and non-tax-audited firms) is accepted.

The findings on ETR1 and ETR2 run counter to what we anticipated, suggesting that in terms of Cressey's (1950) *Fraud Triangle*, the magnitude of income tax expense may be less of a tax malfeasance outcome than a pressure factor (for example high rates may create a pressure/desperation for firms to engage in tax malfeasance). The *tax payable log* and the *tax payable/total revenue* findings are consistent with the above analysis, in that they are higher for the tax-audited firms than for the non-tax-

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<sup>19</sup> Differences in mean values are statistically significant at the 10% level of analysis or better where indicated in Table 2.

audited firms, and the values of these two attributes were statistically significantly different.

The above four findings are all the more surprising, given that the *negative adjustment to prima facie income tax expense due to lower overseas tax rates* showed that the audited firms were very likely using transfers and other off-shore maneuverings to reduce their taxes-payable. Thus, among other things, the findings in Table 2 suggest that the taxes payable of tax-audited firms were very high relative to non-audited firms and may have been even higher if they had not engaged in what the ATO interpreted as probable tax malfeasance.

Finally, the general tax attributes of the JHG (see Table 2) are consistent with the findings for the tax-audited firms, except that many JHG attribute values are larger and the observed values for their *tax payable/total revenue* and *carried forward tax losses* are significantly lower than those of the non-audited firms. However, these lower values may reflect a *special tax deal* the JHG negotiated with the Australian government in 2004.

**Table 2: General tax attributes**

Item description/ <i>fraud-triangle</i> classification		Firm attributes (4 yr. avg.)			Statistical measures	
		JHG	Audited	Non-audited	t-stat	One-tailed p-value
ETR1 (total income tax expense/pre-tax financial accounting income)	P	-66.12	20.41	15.88	-2.307	0.009***
ETR2 (total income tax expense/operating cash flows)	P	39.49	21.63	17.65	-2.366	0.009***
Tax payable (log)	P	16.58	14.45	11.35	-4.171	0.000***
Tax payable/total revenue	P	0.83	1.40	1.21	-1.516	0.065*
Negative adjustment to <i>prima facie</i> income tax expense due to lower overseas tax rates	O	-16.04	-13.30	0.22	1.832	0.034**
Logarithm of negative adjustment to <i>prima facie</i> income tax expense due to R&D)	O	-460000	-1573492	-914040	1.109	0.134
Carried forward tax losses (log)	P	8.43	14.36	11.16	-4.587	0.000***
Has the company recorded tax as a critical uncertainty or uncertain re calculating tax estimates? (1=Y; 0=N)	O	1	0.63	0.34	-6.862	0.000***
One or more subsidiaries in an OECD listed tax haven (1=Y; 0=N)	O	1	0.57	0.30	-6.388	0.000***
Subject to withholding taxes (1=Y; 0=N)	R	1	0.70	0.48	-5.649	0.000***

P = pressure/inducement; R = rationalization/excuse; and O = opportunity/outcome.

The t-test assumes unequal variances.

\*, \*\*, and \*\*\* indicate significance at the .10, .05, and .01 levels, respectively.

## 7.2 Transfer pricing attributes

The purpose of most transfer-pricing rules is to ensure that international related-party transactions are conducted on an *arm's-length* basis so that profits are not shifted to the most favorable tax jurisdiction to minimize a firm's income tax liability (Hamilton, Deutsch, and Raneri, 2001; Eldenburg, Pickering, and Yu, 2003). Multinational firms can lower group tax by strategically setting artificial intercompany transfer prices. The *comparability concept* is pivotal to applying the arm's length tax principle (Arnold and McIntyre, 2002; Sikka and Willmot, 2010)<sup>20</sup>.

An important tax compliance issue is that many firms do not prepare or maintain sufficient documentation on how they established what they call an *arm's length* inter-company transfer price. This *faux pas* may then be compounded by poor disclosure of related-party transactions in the financial accounts and/or the divergent treatment of international business transactions by the firm generally (Newberry and Dhaliwal, 2001). Moreover, the lack of documentation also raises the concern of the ATO and can give rise to amended tax assessments being issued to the firm as a result of transfer-pricing audits (ATO, 2010).

Transfer pricing can also involve the shifting of profits to a subsidiary that is incorporated in a tax haven that has relatively low (if any) corporate tax (Grubert and Mutti, 1991; Harris, Morck, Slemrod, and Yeung, 1993; Desai, Floey, and Hines, 2006; Wilson, 2009; Slemrod and Wilson, 2009). Further, Shackelford, Slemrod, and Sallee (2007) claim that more complicated transfer-pricing arrangements often involve intangible assets (for example R&D expenditure), for which it can be difficult to establish a fair value and taxable income can be transferred internationally. In fact, they claim that tax avoidance opportunities for transfer pricing are greatest amongst multinational firms with high profit margins that are generated from intangible assets (for example the pharmaceutical industry).

Analysis of the transfer pricing attributes (see Table 3) found that, vis-à-vis non-tax-audited firms, tax-audited firms have significantly higher: levels of debt forgiveness, frequency of debt transfer within the corporate group, numbers of interest-free loans, numbers/amounts of payments to group subsidiaries of non-monetary consideration in lieu of cash given without accompanying commercial justification, probability of inadequately-disclosed transfer-pricing support, non-disclosure of differences between inter-group interest rates charged and arm's-length interest rates and/or non-disclosure of supporting commercial reasons for such differences.<sup>21</sup> Based on these results, the subsidiary null hypothesis  $H_2$  is rejected and the alternative (of statistically significant differences in *transfer pricing attributes*, between tax-audited and non-tax-audited firms) is accepted.

Finally, Table 3 also indicates that the JHG, like the tax-audited firms in our sample, has significant elements of debt forgiveness, debt transfer, interest free loans and non-disclosure of transfer pricing support documentation.

<sup>20</sup> The arm's-length principle is generally applied in practice by establishing comparability between the conditions in a controlled transaction (such as transaction between the associated enterprises involved) and the conditions in uncontrolled transactions (such as transactions between independent parties) United Nations (UN, 2009).

<sup>21</sup> Differences in mean values are statistically significant at the 1% level of analysis in Table 3.

**Table 3: Transfer Pricing Attributes**

Item description/ <i>fraud-triangle</i> classification		Firm attributes (4 yr. avg.)			Statistical measures	
		JHG	Audited	Non-audited	t-stat.	One-tailed p-value
Existence of debt forgiveness	O	1	0.15	0.10	-2.767	0.000***
Existence of debt transfer	O	1	0.08	0.05	-2.887	0.000***
Existence of interest-free loans	O	1	0.60	0.45	-3.906	0.000***
Non-monetary consideration without commercial justification	O	0	0.21	0.10	-3.733	0.000***
Non-disclosure of transfer pricing support documentation	O	1	0.92	0.90	-2.497	0.006***

P = pressure/inducement; R = rationalization/excuse; and O = opportunity/outcome.

The t-test assumes unequal variances.

\*, \*\*, and \*\*\* indicate significance at the .10, .05, and .01 levels, respectively.

### 7.3 Risk attributes

A sound framework of risk management in a firm should produce a system of risk oversight and internal control to ensure systems are effective, that strategic, operational, tax and financial risks are identified, and that policies, procedures, tools and charters are in place to manage and monitor risks. Risk management and internal control are an integral part of the governance structure of firms (ASX, 2007).

Corporate compliance programs undertaken by tax authorities (for example the ATO) stress that a strong governance structure with associated internal controls tends to reduce the likelihood that a firm will engage in tax malfeasance. Tax-risk oversight is seen as an essential component of an effective corporate governance structure by tax authorities (ATO, 2010). Further, stakeholders are increasingly interested in whether firms have adequate risk management and internal control systems in place to mitigate tax risks, particularly given the complexity of tax laws and possible uncertainties regarding legal interpretation and application of those tax laws in practice (Coles, Naveen, and Naveen, 2006; Erle, 2008).<sup>22</sup>

Tax authorities consider that oversight of the tax-risk-management process is a responsibility of the board of directors (ATO, 2010) because meeting tax responsibilities is an ethical issue, with the corporate reputation at risk if tax arrangements become the subject of public scrutiny and/or legal action (Erle, 2008). While senior management has responsibility for implementing adequate processes, policies and putting systems in place to ensure that corporate tax risks are minimized (ATO, 2010), oversight by the board of directors ensures that senior management is diligent in those duties. The oversight by the board of directors should verify that the corporate culture and its assurance processes ensure that income tax expenses are

<sup>22</sup> Tax risks comprise compliance risks, transactional risks, operational and reputational risks (KPMG, 2005).

fairly and accurately calculated and that the firm does not engage in arrangements or schemes with the primary objective of tax malfeasance (Erle, 2008).

The directors of many firms acknowledge that tax cannot be managed independently from other business activities and can have a significant influence on decisions made as a result of transactions undertaken (KPMG, 2005)<sup>23</sup>. Nevertheless, there appears to be a clear disparity in the understanding of tax considerations between the board of directors, internal audit and the tax department in many firms (KPMG, 2005).<sup>24</sup>

Our paper examines two important aspects of risk management of tax-audited versus non-tax-audited firms. The first aspect of risk management (RISK1) is whether the board has drafted a formal integrated risk management policy that deals with risk oversight and internal control. ASX Corporate Governance Council's Principle 7 states that the firm should establish a sound risk management policy that deals with risk oversight, risk management, the firm's risk profile and internal control. It is part of the board's oversight role to verify the establishment and implementation of a risk management system. Management should establish and implement a system for identifying, assessing, monitoring and managing risk in the firm.

The second aspect of risk management (RISK2) is whether the CEO/CFO affirms that the firm's risk management, internal compliance and control systems are operating effectively and efficiently. A firm should (ideally) have some means of analyzing the effectiveness of its risk management and internal compliance and control system and of the effectiveness of its implementation. According to ASX Recommendation 7.2, the CEO/CFO should affirm to his/her board, formally and in writing, that the firm's risk management and internal compliance and control system is operating effectively and efficiently.

Analysis of the above discussed attributes and three other perceived risk attributes (see Table 4) found that, vis-à-vis non-tax-audited firms, tax-audited firms have significantly: weaker risk oversight and internal control systems; less effective risk management systems in place; more intensive use of the services of a big-4 auditor; reduced independence in their external auditor; and more expenditure on the tax related services of a big-4 auditor.<sup>25</sup> Based on these results, the subsidiary null hypothesis  $H_3$  is rejected and the alternative (of statistically significant differences in *risk attributes*, between tax-audited and non-tax-audited firms) is accepted.

While the JHG implemented both aspects of risk management since 2003, this occurred after the capital gains tax audit issue which occurred as a result of the

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<sup>23</sup> The results of a survey of board members indicate that 14% of firms had board-approved taxation objectives (KPMG, 2005).

<sup>24</sup> In a survey of board members, regular formal reviews of the tax department by internal audit were carried out in only 22% of firms. Furthermore, only 10 percent of tax departments felt that they were widely understood outside the tax function (KPMG, 2005). Although board members of surveyed firms do not regard reputational risk as acceptable, there is a gap between risk attitudes and actual tax behaviour as evidenced by compliance issues of firms with tax authorities (Erle, 2008; ATO, 2010). This disparity is reflected in fundamental differences in financial, operational, risk and tax characteristics of firms facing tax compliance issues and those that are not subject to tax authority audit.

<sup>25</sup> Differences in mean values are statistically significant at the 10% level of analysis or better where indicated in Table 4.

corporate restructure in 1998 (see above). Moreover, these controls are only as good as the willingness of the firm's principals to implement and act on them; rather than using them as mere window dressing to enhance perception of the firm's public reputation.

Aggressive tax reporting might be constrained by the external auditors of accounting firms. However, it is possible that non-audit services could impair the independence provided to an audit client (Brown, Falaschetti, and Orlando, 2010). There is ongoing debate about the suitability of accounting firms providing non-audit services (Larcker and Richardson, 2004). Critics contend that the substantial fees paid to auditors (especially fees for non-audit services) increase the financial reliance of the auditor on the client (Becker, DeFond, Jambalvo, and Subramanyam, 1998). Thus, auditor's independence may be compromised as they become reluctant to highlight problems in the client's financial reports (Frankel et al., 2002). The use of a big-4 audit firm may have a significant bearing on corporate tax malfeasance given that these firms often provide specific services designed to reduce the taxable income of firms. Badertscher et al. (2009) claim that implementation of successful tax malfeasance strategies (for example complex tax shelter transactions) may require the use of high-priced consultants such as those working at big-4 audit firms. In Table 4, we find that ATO audited firms use a big-4 auditor more extensively than non-tax audited firms, the external auditors of firms subject to tax audit activity are less independent compared to those of non-tax audited firms, and that these external audit firms derive a significantly greater amount of non-audit fees from taxation related services.<sup>26</sup>

Finally, in relation to the JHG, Table 4 shows that a big-4 external auditor is used which appears to be even more non-independent than those of the tax audited firms. Finally, taxation services constitute a relatively large proportion (40%) of total fees paid by JHG to its external auditor, which is much greater than the tax audited firms, who were significantly (5% level) greater than the non-audited firms.

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<sup>26</sup> See note 22, above.

**Table 4: Risk attributes**

Item description/ <i>fraud-triangle</i> classification		Firm attributes (4 yr. avg.)			Statistical measures	
		JHG	Audited	Non-audited	t-stat.	One-tailed p-value
RISK1: Formal integrated risk management policy on risk over-sight & management & internal control (1=Y; 0=N)	O	1	0.927	0.935	-1.578	0.058*
RISK2: Certification by CEO/CFO that the firm's risk management, internal compliance & control systems are operating effectively and efficiently (1=Y; 0=N)	O	1	0.818	0.912	-2.674	0.002***
Employment of a big-4 external auditor (1=Y; 0=N)	O	1	0.927	0.835	-4.895	0.000***
External auditor non-independence	O	40.35	35.411	28.119	-2.685	0.003***
Taxation services performed by big-4 auditor	O	40.00	22.759	15.829	-1.685	0.047**

P = pressure/inducement; R = rationalization/excuse; and O = opportunity/outcome.

The t-test assumes unequal variances.

\*, \*\*, and \*\*\* indicate significance at the .10, .05, and .01 levels, respectively.

## 7.4 Operational attributes

As noted in Section 6 of the paper (above), the research design in this study sought (via careful exclusion of categories of firms from the initial sample of firms, choice of variables, and type of analysis) to highlight the predilection for tax malefeasance of the sampled firms and to exclude or isolate any irrelevant differences. This subsection analyzes key operational attributes to determine if they add insight into the predilection for corporate tax malefeasance, and whether it might be useful for future research to expand their consideration, especially those (for example firm size and leverage) that might add to the outcomes of future research.

Analysis of the operational attributes (see Table 5) found that, vis-à-vis non-tax-audited firms, tax-audited firms are significantly more likely to: be larger, be more profitable, be more debt intensive in their capital structure, have a higher proportion of foreign derived revenue as a share of total assets, have more foreign-controlled subsidiaries, use subsidiaries domiciled in one or more tax havens (see OECD, 2006) and be subject to withholding taxes.<sup>27</sup> Based on these results, the subsidiary null hypothesis  $H_4$  is rejected and the alternative (of statistically significant differences in *operational features/attributes*, between tax-audited and non-tax-audited firms) is accepted.

Finally, Table 5 also shows that the JHG (like the tax-audited firms) is relatively large, highly leveraged and has an extensive network of foreign incorporated subsidiaries. The JHG, due (in part) to obligations arising from past-CSM issues and ongoing

<sup>27</sup> Differences in mean values are statistically significant at the 10% level of analysis or better where indicated in Table 5.

efforts to evade those obligations, has a negative return on its assets, a lower than average capital expenditure scaled against total assets, relatively lower foreign revenue scaled against total assets and relatively more foreign subsidiaries as a proportion of total subsidiaries.

**Table 5: Operational attributes**

Item description/ <i>fraud-triangle</i> classification		Firm attributes (4 yr. avg.)			Statistical measures	
		JHG	Audited	Non-audited	t-stat.	One-tailed p-value
Firm size (log)	P	21.53	21.54	20.02	-9.603	0.000***
Firm leverage (square root)	P	0.99	0.72	0.63	-9.026	0.000***
Return on assets	P	-7.57	6.50	5.40	-0.979	0.0832*
Capital expenditure/total assets	O	3.64	11.95	7.19	-1.014	0.0788*
Foreign revenue/total assets	O	87.16	279.37	181.76	-0.765	0.0987*
Foreign incorporated subsidiaries	O	50.67	35.07	30.40	-1.648	0.050**

P = pressure/inducement; R = rationalization/excuse; and O = opportunity/outcome.

The t-test assumes unequal variances.

\*, \*\*, and \*\*\* indicate significance at the .10, .05, and .01 levels, respectively.

## 8. CONCLUSION

Tax malfeasance, as a pooling of the social wrong of tax avoidance and the criminal act of tax evasion, is a variant of or closely allied with fraud. On that basis, this study adapts Cressey's (1950) Fraud Triangle to visualize corporate tax malfeasance as a process involving corporate tax malefactors who: (1) are under pressure to enable the firm to wrongfully benefit by failing to fully discharge its tax obligations; (2) rationalize away the wrongful nature of the associated breach of CSR; and (3) can create opportunity to commit tax malfeasance by breaching, bypassing or otherwise overriding the firm's CCRS that should otherwise make tax malfeasance infeasible, or at least more difficult to achieve. Further, based on Cressey's (1950) *Fraud Triangle*, we argued that firms engaging in tax malfeasance are likely to exhibit many traits in common and that many of those traits, being of little use to firms who honor their tax obligations, will tend to be isolated to and thus indicative of corporate tax malfeasance.

We found that the tax-audited firms have statistically significant differences vis-à-vis the non-tax-audited firms, and that tax-audited firms can also be clearly associated with tax malfeasance. Moreover, a review of corresponding attributes of the JHG tended to have mean values that were closer to those of the tax-audited firms than the non-audited ones, and the few values that ran counter to this trend were explainable by corporate losses arising from previous CSM and by tax concessions negotiated by the JHG.



The findings of this paper have several important policy implications, including:

- Tax malfeasance is closely allied with or is a variant of fraud. Thus, fraud-prevention models like Cressey's (1950) *Fraud Triangle* can give valuable insight into tax malfeasance antecedent processes in the form of pressure, rationalization and opportunity;
- A model of the motivators/pressure and the thinking/rationalization of tax malfeasance perpetrators and how they find or create tax malfeasance opportunities increase our understanding of how the antecedent processes of tax malfeasance tend to shift their firm's attributes away from patterns that are normal to firms who faithfully discharge their tax obligations;
- Top 300 publicly-listed Australian firms audited by the ATO for suspected tax malfeasance have common attributes that are markedly different from those of equivalent firms that were not audited. This suggests that firms who engage in tax malfeasance can be profiled, based on key attributes;
- Many attributes of tax-audited firms are relevant not only to the JHG, but also to other major firms currently being reviewed or audited by the ATO;
- A corporate-tax-malefactor profile should be useful to tax agencies in targeting their tax compliance programs, including risk reviews and audits; and
- Given that many of the profile attributes are pathways to facilitate the commission and camouflage of tax malfeasance, another benefit of revealing them as potential audit triggers may be to make tax malfeasance more difficult and risky for corporate-tax malefactors.

As corporate stakeholders (particularly shareholders) bear the brunt of firms being found guilty of tax malfeasance, it is not surprising that they are increasingly concerned about the competence of a firm's CCRS (Henderson Global Investors, 2005; KPMG, 2005). Competency in such systems should include being able properly identify and resolve tax risks, complex tax laws/regulations and uncertainties regarding the actual interpretation and application of tax laws and regulations (Slemrod, 2004; 2007). If CCRS are inadequate (and especially if they are degraded so as to be inadequate), it is a high-risk indicator for corporate tax malfeasance and thus should be a prime tax review or audit trigger.

Our findings suggest and cross-link fundamental theoretical and empirical linkages between corporate attributes and tax malfeasance, so they should be of significant interest to stakeholders, policymakers and regulators. Finally, as the corporate attributes identified in this study are likely to facilitate the commission and camouflage of tax malfeasance, exposing them to public scrutiny is likely to make corporate tax malfeasance more difficult and risky for firms in practice.

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# Determinants of tax compliance behaviour of corporate taxpayers in Malaysia

Noor Sharoja Sapiei<sup>1</sup>, Jeyapalan Kasipillai<sup>2</sup> and Uchenna Cyril Eze<sup>3</sup>

## ***Abstract***

This study focuses on the determinants of taxpayer compliance behaviour with respect to corporate income tax reporting requirements in Malaysia. A researcher-administered questionnaire survey method for data collection was utilised. The findings of this study reveal that business age, tax liability and tax complexity consistently influence the likelihood of tax non-compliance behaviour in the areas of under-reporting income, over-claiming expenses and overall non-compliance. Nonetheless, the tax compliance costs have an insignificant relationship with the non-compliance behaviour of corporate taxpayers. The remaining factors examined are significant determinants in at least one type of non-compliance behaviour.

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<sup>1</sup> Dr Noor Sharoja Sapiei is a senior lecturer in the Department of Accounting, Faculty of Business and Accountancy, University of Malaya, Malaysia.

<sup>2</sup> Professor Jeyapalan Kasipillai is a professor at Monash University Malaysia, an adjunct senior research fellow at Monash University Australia, and serves as a council member of the Chartered Tax Institute of Malaysia.

<sup>3</sup> Dr Uchenna Cyril Eze is an assistant professor at BNU-HKBU United International College, China.

## 1. INTRODUCTION

The introduction of the self-assessment system (SAS), which replaced the official assessment system (OAS) from 2001, is a major reform of the Malaysian tax system since the inception of the Income Tax Act (ITA) in 1967.<sup>4</sup> The SAS imposes greater accountability upon taxpayers in terms of computational, recordkeeping and filing requirements. Moreover, as tax officials are no longer reviewing all returns filed under the SAS, more resources are available for enforcement activities to ensure greater tax compliance. Tax compliance behaviour has always been an area of concern to tax policy makers, as non-compliance with reporting requirements affects revenue collection and the ability of the government to achieve its fiscal and social goals.<sup>5</sup>

Under self-assessment, various factors may have an impact on the level of tax compliance. To date, however, very few empirical studies to identify the determinants of corporate taxpayer compliance behaviour have been conducted, especially studies involving large corporations. Corporate Income Tax (CIT) is an important source of revenue for Malaysia's federal government, accounting for about 50% of the Inland Revenue Board of Malaysia's (IRBM) tax collection in 2009. This warrants research that can provide insight into the reasons for non-compliance among corporate taxpayers, hence contributing to the tax literature on CIT compliance behaviour in public companies. The relationships between corporate characteristics, tax compliance costs, attitudinal aspects and the compliance behaviour of Malaysian public listed companies (PLCs) are examined in this study.

## 2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Tax compliance is defined as the accurate reporting of income and claiming of expenses in accordance with stipulated tax laws.<sup>6</sup> Thus, the failure of corporations to accurately report or pay CIT is considered corporate tax non-compliance.<sup>7</sup> There are two main approaches to understand tax compliance issues: the economic approach and behavioural approach.<sup>8</sup> The economic approach is premised on the concept of economic rationality, while the behavioural approach applies concepts from disciplines such as psychology and sociology.

The basic theoretical model applied in the economic approach is built on the work of Becker (1968) who analysed criminal behaviour using an economic framework known as the economics-of-crime model.<sup>9</sup> Allingham and Sandmo first employed this model in the context of tax compliance study in 1972.<sup>10</sup> The model is based on an expected

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<sup>4</sup> Kasipillai J, *A comprehensive guide to Malaysian taxation under self-assessment system* (2nd ed, McGraw Hill, Selangor, 2005) pp 31–33.

<sup>5</sup> Tan LM and Sawyer AJ, "A synopsis of taxpayer compliance studies — overseas vis-à-vis New Zealand" (2003) 9(4) *New Zealand Journal of Taxation Law and Policy* 431.

<sup>6</sup> Alm J, "A perspective on the experimental analysis of taxpayer reporting" (1991) 66(3) *Accounting Review* 577.

<sup>7</sup> Slemrod J, "The economics of corporate tax selfishness" (2004) 62(4) *National Tax Journal* 878.

<sup>8</sup> James S, Hasseldine J, Hite P and Toumi M, "Developing a tax compliance strategy for revenue services" (2001) 55(4) *Bulletin for International Fiscal Documentation* 158.

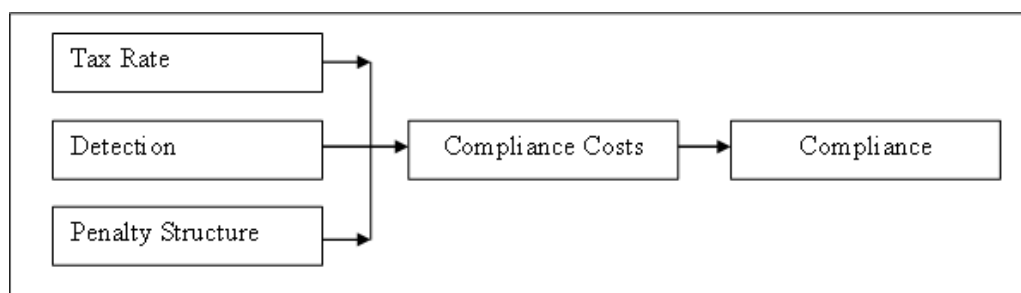
<sup>9</sup> Becker GS, "Crime and punishment: An economic approach" (1968) 76(2) *Journal of Political Economy* 169–217.

<sup>10</sup> Allingham MG and Sandmo A, "Income tax evasion: A theoretical analysis" (1972) 1(3–4) *Journal of Public Economics* 323–338.

utility theory and a deterrence theory. The expected utility theory views taxpayers as perfectly amoral utility maximisers, who choose to evade taxes whenever the expected gain exceeds the cost of evasion (Allingham & Sandmo, 1972).<sup>11</sup> The deterrence theory is concerned with the effects of sanctions and sanction threats (Cuccia, 1994),<sup>12</sup> where an increase in the severity of penalties and the certainty of their imposition will discourage undesirable behaviour (Pate & Hamilton, 1992).<sup>13</sup> Their theoretical analysis suggested that punishment and/or sanctions determined taxpayer compliance behaviour and that an increase in the penalty rate and a greater probability of detection would result in lower non-compliance.

Almost all economic approaches to tax compliance continued with this framework.<sup>14</sup> Within the framework, the tax rate, the probability of detection and the penalty structure determine the monetary cost of compliance, which in turn determines taxpayer compliance behaviour.<sup>15</sup> This framework was configured as the financial self-interest model (Figure 1). It has become a prominent approach in investigating taxpayer compliance behaviour. Based on this model, compliance behaviour was determined by the rational economic consideration of perceived costs and benefits derived from the specific action of taxpayers.

**Figure 1: Financial Self-Interest Model**



Source: Fischer, Wartick and Mark (1992, p.3)

In contrast, the behavioural approach assumes that individuals are not simply independent, selfish, utility maximizers but that they interact according to differing attitudes, beliefs, norms and roles (Elffers, 1991).<sup>16</sup> The behavioural perspective incorporates sociological and psychological factors, such as age, gender, ethnicity, education, culture, institutional influence, peer influence, ethics and tax morale, as factors that may affect taxpayer compliance behaviour (Figure 2).<sup>17</sup> This model is

<sup>11</sup> Allingham and Sandmo, n 7 at 331-332.

<sup>12</sup> Cuccia AD, "The effects of increased sanctions on paid tax preparers: Integrating economic and psychological factors" (1994) 16(1) *The Journal of the American Tax Association* 41-66.

<sup>13</sup> Pate AM and Hamilton EE, "Formal and Informal Deterrents to Domestic Violence: The Dade County Spouse Assault Experiment" (1992) 57(5) *American Sociological Review* 692.

<sup>14</sup> See for example, Hanlon M, Mills L and Slemrod J, An empirical examination of corporate tax non-compliance (Working Paper No.1025, University of Michigan, 2005). See also Joulfaian D, "Corporate income tax evasion and managerial preferences" (2000) 82(4) *The Review of Economic Statistics* 698-701.

<sup>15</sup> Fischer C, Wartick M and Mark M, "Detection Probability and Taxpayer Compliance: A Review of the Literature" (1992) 11(1) *Journal of Accounting Literature* 3.

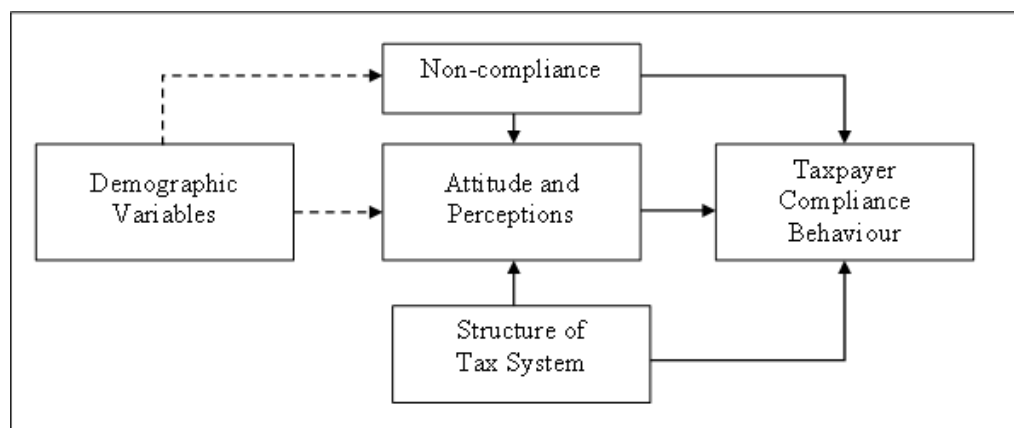
<sup>16</sup> Elffers H, Weigel RH and Hessing DJ, "The Consequences of Different Strategies for Measuring Tax Evasion Behaviour" (1992) 8(3) *Journal of Economic Psychology* 318-319.

<sup>17</sup> Fischer, Wartick and Mark, n 12 at 3. The authors expanded the financial self-interest model by incorporating economic, sociological and psychological variables.



significant as it predicts that demographic variables indirectly influence tax compliance behaviour through their effects on non-compliance opportunities and attitudes.

**Figure 2: Expanded Model of Taxpayer Compliance**



Source: Fischer et al. (1992, p.4)

Both the economic and behavioural approaches have contributed to the understanding of tax compliance behaviour. A study designed on a blend of both approaches seems most appropriate as a single approach is not likely to be totally effective in explaining the compliance behaviour of taxpayers.<sup>18</sup> In addition, examining taxpayer behaviour is complex and challenging as the relevant literature emanates from a variety of disciplines including economics, psychology, and sociology.<sup>19</sup>

Empirical literature on tax compliance has been concerned mainly with individual taxpayers while the analysis of corporate tax compliance has been rather neglected. Despite evidence that corporations have accounted for an increasingly larger portion of total tax evasion as compared to individual taxpayers, the finding has not attracted scholarly analysis.<sup>20</sup> Rice<sup>21</sup> suggested that the difficulty in capturing analytically the non-compliance decisions of corporate taxpayers was a possible explanation for the lack of research on corporate tax evasion. Nonetheless, tax compliance studies on individual taxpayers have provided a formal framework to analyse the compliance decisions of corporate taxpayers.<sup>22</sup> A review of the extensive literature on factors affecting individual tax compliance behaviour uncovered three main categories of determinants of such behaviour. These categories include demographic, economic and

<sup>18</sup> Hasseldine J and Bebbington KJ, "Blending economic deterrence and fiscal psychology models in the design of responses to tax evasion: the New Zealand experience" 1991 12(2) *Journal of Economic Psychology* 320.

<sup>19</sup> McKerchar M, Hodgson H and Datt K, "Is there a perception of revenue bias on the part of the ATO in private binding rulings on large, complex issues?" 2008 23(3) *Australian Tax Forum* 312.

<sup>20</sup> Rice E, "The corporate tax gap: Evidence on tax compliance by small corporations" in Slemrod J (ed), *Why people pay taxes: Tax compliance and enforcement* (University of Michigan Press, Ann Arbor, 1992) p 126.

<sup>21</sup> Rice, n 17.

<sup>22</sup> See for example, Rice, n 17 at 127. See also Kamdar N, "Corporate income tax compliance: A time series analysis" (1997) 25(1) *Atlantic Economic Journal* 38.

behavioural determinants.<sup>23</sup> Demographic determinants include age, gender, education and occupation, while economic determinants include income level, income source, tax rates and sanctions. Behavioural determinants include complexity, fairness, revenue authority contact, peer influence and ethics.

Rice<sup>24</sup> examined the nature of medium-sized corporations that evade income tax in the US, measured in terms of unreported income. Micro-data from the 1980 Taxpayer Compliance Measurement Program (TCMP) database, accessible from the Internal Revenue Service (IRS), were utilised for the study.<sup>25</sup> Employing a similar measurement, Joulfaian<sup>26</sup> used managers' understatements of their personal income tax as proxies for corporate tax non-compliance. The study investigated the relationship between managerial preferences, corporate characteristics and undeclared income.

Studies reviewed in this paper on the tax compliance of corporate taxpayers, except for Abdul-Jabbar,<sup>27</sup> utilised government reported data and were conducted in the US.<sup>28</sup> Rice<sup>29</sup> and Joulfaian<sup>30</sup> utilised the TCMP data, while Kamdar<sup>31</sup> and Hanlon, Mills and Slemrod<sup>32</sup> were based on the annual report of IRS reported data. Tax non-compliance in these US studies was measured by either determining the undeclared amount of corporate net income,<sup>33</sup> or by using the tax deficiencies found by the IRS during audits.<sup>34</sup>

These approaches, however, were subject to data limitations due to confidentiality requirements surrounding taxpayer returns<sup>35</sup> and restricted access to IRS audit selection criteria.<sup>36</sup> Other issues surrounding the use of these data included ambiguity of what is considered actual non-compliance, the possibility of mistakes in characterising legitimate tax planning as non-compliance, and some under-reporting of income that may not be detected through tax audits.<sup>37</sup> The question is whether government-reported data obtained through financial audits would be able to accurately measure the tax compliance decisions of corporate taxpayers.

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<sup>23</sup> Richardson G, "Determinants of tax evasion: A cross-country investigation" (2006) 15(2) *Journal of International Accounting, Auditing and Taxation* 151.

<sup>24</sup> Rice, n 17.

<sup>25</sup> TCMP data were based on studies conducted by the IRS to estimate revenue loss because of tax evasion through line-by-line audits of tax returns.

<sup>26</sup> Joulfaian, n 11 at 699.

<sup>27</sup> Abdul-Jabbar H, *Income tax non-compliance of small and medium enterprises in Malaysia: Determinants and tax compliance costs* (Unpublished thesis, Curtin University of Technology, Perth, Australia, 2009).

<sup>28</sup> Government-reported data, also known as tax audits, rely on data within and/or compiled through audit activities conducted by the tax authorities.

<sup>29</sup> Rice, n 17.

<sup>30</sup> Joulfaian, n 11.

<sup>31</sup> Kamdar, n 18.

<sup>32</sup> Hanlon, Mills and Slemrod, n 11.

<sup>33</sup> See Rice, n 17 and Joulfaian, n 11.

<sup>34</sup> See Kamdar, n 18 and Hanlon, Mills and Slemrod, n 11.

<sup>35</sup> Hite PA, "An examination of the impact of subject selection on hypothetical and self-reported taxpayer non-compliance" (1988) 9 *Journal of Economic Psychology* 446.

<sup>36</sup> Kamdar, n 18.

<sup>37</sup> Slemrod J, "Cheating ourselves: The economics of tax evasion" 2007 21(1) *Journal of Economic Perspectives* 31–32.

Despite any shortcomings, findings from prior studies have provided evidence of the factors affecting the reporting decisions of corporations. Rice<sup>38</sup> found that profit performance influenced tax compliance but did not observe a relationship between firm size and tax compliance. Tax compliance was positively associated with public disclosure and negatively associated with the marginal tax rate. A study by Kamdar<sup>39</sup> discovered that audit rates and profit performance had a positive and significant impact on tax compliance. No significant relationships were found between tax compliance and true income, marginal tax rates, probability of detection, penalties and other socio-economic factors. The author suggested that greater audit coverage could act as an effective deterrent to corporate non-compliance, resulting in a substantial rise in tax revenues.

Joulfaian<sup>40</sup> ascertained that non-compliant corporations are more likely to be managed by executives who have failed to comply with their individual income tax obligations, and vice-versa. The author proposed future studies to include managerial preferences as one of the tax compliance determinants. Moreover, marginal tax rates, audit rate, firm size and income level were all found to influence non-compliance behaviour; foreign ownership was not. Another US study by Hanlon, Mills and Slemrod,<sup>41</sup> estimated corporate non-compliance to be 13% of the tax liability, as measured by deficiencies proposed upon audit investigation. The non-compliance rate for corporations, relative to their size, was U-shaped: larger companies were observed to be more non-compliant than their smaller counterparts, but medium-sized companies had the lowest non-compliance rate. According to the authors, the unexpected finding was connected with the opportunity for non-compliance. Concerning corporate characteristics, size, industry, multi-nationality, being publicly traded, the presence of intangible assets and executive compensation determined corporate compliance behaviour. Two other corporate characteristics, effective tax rates and the quality of governance, had no effect on the compliance behaviour of corporate taxpayers.

Given the limitations and confidentiality issues associated with using government data in Malaysia, Abdul-Jabbar<sup>42</sup> examined the corporate tax non-compliance of SMEs using a survey approach. He adopted hypothetical tax scenarios in measuring tax compliance behaviour. Abdul-Jabbar<sup>43</sup> concluded that tax complexity and the probability of a tax audit significantly influenced non-compliant behaviour, while the reverse was true for business size, tax level, compliance costs and perceived tax fairness. His findings on the impact of business age, industry sector, tax rate and incentives on the compliance behaviour of corporate SMEs were inconclusive.

A review of the literature found that limited empirical research was utilised to evaluate the compliance behaviour of corporate taxpayers. The majority of tax compliance literature focused on the determinants of tax compliance behaviour of individual taxpayers. Findings from limited studies using the compliance data of large corporate taxpayers have provided some evidence of the determinants of the compliance behaviour of corporate taxpayers. Some of the main determinants are corporate characteristics (such as firm size, industry sector, multi-nationality, and whether the

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<sup>38</sup> Rice, n 17 at 151-152.

<sup>39</sup> Kamdar, n 18 at 46.

<sup>40</sup> Joulfaian, n 11 at 701.

<sup>41</sup> Hanlon, Mills and Slemrod, n 11 at 29.

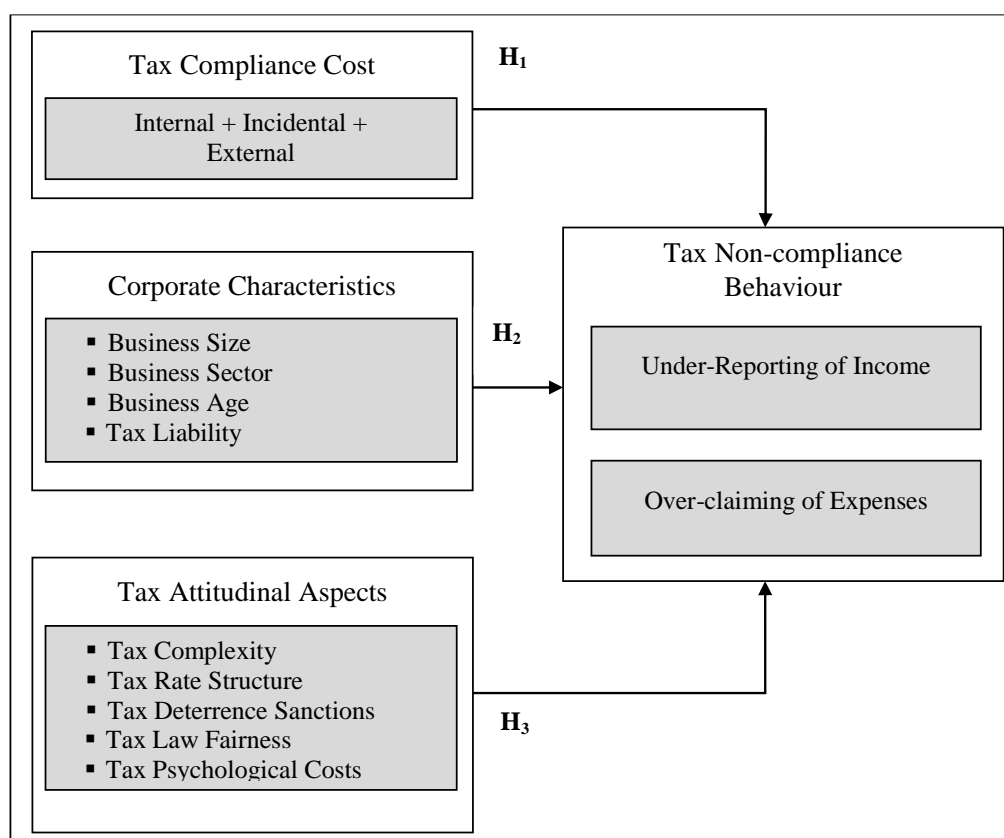
<sup>42</sup> Abdul-Jabbar, n 23.

<sup>43</sup> Abdul-Jabbar, n 23 at 189-180

firm is publicly traded), and economic characteristics (such as marginal tax rates, audit rates and penalty rates).

As mentioned previously, these existing studies were based on IRS reported data in the US, except for the Abdul-Jabbar<sup>44</sup> study on SMEs, where the researcher utilised a survey method. As the latter study was only limited to SMEs, no research so far has attempted to study large corporate taxpayers utilising the taxpayer self-reporting approach. In addition, the limited literature on the compliance decisions of corporate taxpayers is mostly restricted to studies on corporate determinants utilising government reported data. Hence, very little is known about the influence of tax compliance costs, and economic and behavioural factors on taxpayer compliance behaviour. These represent the significance of this study. We developed the research model for this study (Figure 3) based on research gaps identified from the literature of tax compliance behaviour.

**Figure 3: Research model of this study**



The model was designed to explore the extent of the relationship between the independent variables (corporate characteristics, tax compliance costs and tax attitudinal aspects) and the dependent variable (tax non-compliance behaviour). In line with the underpinning theories and past empirical findings on corporate taxpayer compliance behaviour, three main hypotheses were formulated. The development of each hypothesis is discussed under the following three captions:

<sup>44</sup> Abdul-Jabbar, n 23.

## 2.1 Tax compliance costs and non-compliance behaviour

Tax compliance costs are those incurred by taxpayers due to their obligations to comply with a country's relevant tax laws. The term 'corporate tax compliance costs' refers to the value of resources expended by corporate taxpayers in complying with tax regulations.<sup>45</sup> Tax compliance costs consist of internal costs (value of time spent by company staff on tax matters), external costs (fees paid to external tax professionals) and incidental costs (stationery items, computer, telephone and litigation costs). Some of the theoretical literature has suggested tax compliance costs as a possible determinant of tax compliance behaviour.<sup>46</sup> These authors have proposed that the level of compliance costs could potentially be one of the factors affecting the compliance decisions of corporate taxpayers. As such, Hypothesis 1 (**H<sub>1</sub>**) was formulated as follows:

***H<sub>1</sub>** : A reduction in tax compliance costs reduces the level of non-compliance among corporate taxpayers.*

## 2.2 Corporate characteristics and non-compliance behaviour

A review of past literature identified some corporate characteristics as determinants of corporate taxpayer compliance decisions. Even though there are mixed results from the limited study of corporate taxpayer compliance behaviour, the empirical findings identified some characteristics that influence taxpayer compliance levels.<sup>47</sup> The results also highlighted that the significance of the relationship between the determinants and tax compliance behaviour should be confirmed through empirical work in other tax jurisdictions and/or the study of other types of taxpayers. As such, Hypothesis 2 (**H<sub>2</sub>**) and the sub-hypotheses were formulated as follows:

***H<sub>2</sub>** : There is a relationship between corporate characteristics and non-compliance of corporate taxpayers.*

***H<sub>2a</sub>** : There is a relationship between business size and non-compliance of corporate taxpayers.*

***H<sub>2b</sub>** : There is a relationship between business sectors and non-compliance of corporate taxpayers.*

***H<sub>2c</sub>** : There is a relationship between business length and non-compliance of corporate taxpayers.*

***H<sub>2d</sub>** : There is a relationship between business tax liability and non-compliance of corporate taxpayers.*

<sup>45</sup> Tran-Nam B and Glover J, "Tax reform in Australia: Impacts of tax compliance costs on small business" 2002 5(3) *Journal of Australian Taxation* 342.

<sup>46</sup> See for example, Slemrod, n 4. See also, Tran-Nam B, "Tax compliance research: An economic perspective" 2003 9(4) *New Zealand Journal of Taxation Law and Policy* 455–468.

<sup>47</sup> See Abdul-Jabbar, n 23, Hanlon, Mills and Slemrod, n 11, Joulfaian, n 11 and Rice, n 17.

### 2.3 Tax attitudinal aspects and non-compliance behaviour

There are propositions in the literature suggesting that the compliance behaviour of taxpayers is also influenced by their attitudes and perceptions.<sup>48</sup> In order to address the research problem comprehensively, this study attempted to validate a number of propositions that were tested in earlier tax compliance behaviour studies. The propositions are grouped into tax attitudinal aspect variables consisting of perceptions on tax law complexity, fairness in the tax rate structure, tax deterrence sanctions, tax law fairness and tax psychological costs. As such, Hypothesis 3 ( $H_3$ ) and the sub-hypotheses were formulated as follows:

*$H_3$  : There is a relationship between tax attitudinal aspects and non-compliance of corporate taxpayers.*

*$H_{3a}$  : There is a relationship between perceived tax complexity and non-compliance of corporate taxpayers.*

*$H_{3b}$  : There is a relationship between perceived tax deterrence sanctions and non-compliance of corporate taxpayers.*

*$H_{3c}$  : There is a relationship between perceived fairness in the tax rate structure and non-compliance of corporate taxpayers.*

*$H_{3d}$  : There is a relationship between perceived fairness of the tax system and non-compliance of corporate taxpayers.*

*$H_{3e}$  : There is a relationship between perceived level of psychological costs and non-compliance of corporate taxpayers.*

## 3. RESEARCH METHOD

Three main approaches have been employed in tax compliance research: experimental, survey and tax audit approaches.<sup>49</sup> Each of these approaches has been employed in tax research with its own merits and limitations. An experimental approach was unsuitable for this study because students were normally used as experimental subjects, which is only appropriate for studies related to individual taxpayers. A tax audit approach was not possible, given the confidentiality requirements surrounding corporate tax returns and the limitation in utilising IRBM data. Therefore, a survey approach which has been used in prior studies to measure tax compliance behaviour of corporate taxpayers was deemed most appropriate for this study.<sup>50</sup>

<sup>48</sup> Ajzen I and Fishbein M "Attitude-behaviour relations: A theoretical analysis and review of empirical research" (1977) 84(5) *Psychological Bulletin* 899-900.

<sup>49</sup> See Elffers H, Robben HJ and Hessing DJ, "On measuring tax evasion" (1992) 13 *Journal of Economic Psychology* 545.

<sup>50</sup> Richardson M and Sawyer AJ, "A taxonomy of the tax compliance literature: further findings, problems and prospects" 2001 16(2) *Australian Tax Forum* 150-151.

### 3.1 Research sampling design

The target population for this study was large corporate taxpayers registered with the IRBM. The population of corporate taxpayers registered with the IRBM as at 31 December 2009 totalled 451,488 companies,<sup>51</sup> while there were 4,582 large companies in Malaysia.<sup>52</sup> The sample of corporate taxpayers was drawn from the ‘Malaysian Top 500 Largest Listed Corporations 2008–2009’ published directory.<sup>53</sup> Companies in East Malaysia (Sabah and Sarawak) were excluded from the main sample due to budgetary and time constraints. Sectors with fewer companies were excluded due to the low level of representation. These sectors included infrastructure project companies, hotels, closed-end funds and mining companies. After excluding these companies and sectors, the final sample numbered 473 companies.

### 3.2 Research instruments

In designing the research instruments, the available questionnaires on tax compliance behaviour were considered first.<sup>54</sup> The questions, with some innovations and modifications made to them to account for the specific characteristics of the Malaysian corporate tax system, focused on factors that were considered relevant to this study of large corporate taxpayers. The questionnaire comprised four parts, referred to as Parts A to D. Part A consisted of questions about the costs of complying with corporate income tax law. Part B elicited information on respondents’ perceptions and opinions on a number of tax attitudinal aspects and Part C sought information on compliance behaviours of corporate taxpayers. Part D consisted of questions regarding the economic and demographic characteristics of companies.

### 3.3 Measurement of variables

The measurement of variables was based on the established sources of reference (Table 1).

**Table 1: Variables and sources of reference**

<i>Variables</i>	<i>Main Sources of Reference</i>
Tax Compliance Costs	Evans, Ritchie, Tran-Nam and Walpole (1997); Pope (1993)
Tax Attitudinal Aspects	Christensen et al. (1994); Christensen and Hite (1997); Roberts (1994); Yesegat (2009)
Tax Compliance Behaviours	Chan, Troutman and O’Bryan (2000); Kaplan, Newberry and Reckers (1997)

#### 3.3.1 Tax compliance costs

In this study, the measurement of estimated tax compliance costs applied most of the techniques employed by established researchers who have carried out studies in this

<sup>51</sup> Inland Revenue Board Malaysia (IRB), Annual Report 2009. (Inland Revenue Board Malaysia) at <http://www.hasil.gov.my/>

<sup>52</sup> Department of Statistics Malaysia, 2011. Census of establishment and enterprises. Kuala Lumpur.

<sup>53</sup> The sampling frame from the IRBM’s database of registered corporate taxpayers would provide a better sample but the researcher was not able to obtain the information due to confidentiality reasons.

<sup>54</sup> See for example, Abdul-Jabbar, n 23.

field.<sup>55</sup> Consistent with these studies, computations of compliance costs for corporate taxpayers included all measurable components, namely, the internal, external and incidental costs of tax compliance activities (Table 2).

**Table 2: Cost components and cost computations**

<i>Cost Components</i>	<i>Cost Computations</i>
Internal	Computed by multiplying annual time spent on tax activities to their respective hourly wage rate.
Incidental	Computed by adding costs incurred within companies and by external tax professionals.
External	Money cost charged by external tax professionals solely on tax activities

### 3.3.2 Tax attitudinal aspects

Measurement of tax attitudinal aspects refers to the measurement of the managerial attitudes of respondents towards some features of taxation. The description of each aspect and the sources referred to in the development of questions regarding attitudinal aspects were based on a number of earlier tax compliance studies (Table 3).<sup>56</sup> Respondents were requested to indicate their agreement or disagreement with each statement using a six-point Likert scale.

### 3.3.3 Tax compliance behaviour

In this study, tax compliance behaviour was measured by gathering responses from hypothetical tax scenarios. These scenarios were introduced to mitigate the sensitive nature of the questions involved so that respondents would be more likely to provide truthful responses.<sup>57</sup> As most corporations would have strong incentives to avoid revealing their non-compliance decisions, any direct measures would invariably suffer from substantial measurement errors.<sup>58</sup> In this study, a modified version of the non-compliance scenarios developed by Chan, Troutman and O'Bryan<sup>59</sup> for individuals was utilised to gather data on the hypothetical non-compliance behaviour of corporate taxpayers. The respondents were requested to read two tax non-compliance scenarios

<sup>55</sup> See Evans C, Ritchie K, Tran-Nam B and Walpole M, A report into taxpayer costs of compliance (Australian Government Publishing Service, Canberra, 1997). See also, Pope J, The compliance costs of major Commonwealth taxes in Australia. (Unpublished thesis, Curtin University of Technology, Perth, Australia, 1993).

<sup>56</sup> See Christensen AL, Weihrich SG and Gerbing MD, "The impact of education on perceptions of tax fairness" (1994) 6(3) *Advances in Taxation* 63-94; Christensen AL and Hite P, "A study of the effect of taxpayer risk perceptions on the ambiguous compliance decisions" (1997) 19(1) *Journal of the American Taxation Association* 1-18; Roberts ML, "An experimental approach to changing taxpayers' attitudes towards fairness and compliance via television" (1994) 16(1) *The Journal of the American Taxation Association* 67-86; and Yesegat WA, Value added tax in Ethiopia: A study of operating costs and compliance (Unpublished thesis. ATAX, University of New South Wales, Sydney, Australia, 2009).

<sup>57</sup> Kaplan SE, Reckers PMJ and Roark SJ, "An attribution theory analysis of tax evasion related judgments" (1988) 13(4) *Accounting, Organizations and Society* 372.

<sup>58</sup> Rice, n 17 at 126.

<sup>59</sup> Chan CW, Troutman CS and O'Bryan D, "An expanded model of taxpayer compliance: Empirical evidence from the United States and Hong Kong" (2000) 9(2) *Journal of International Accounting, Auditing and Taxation* 83-103.



about the under-reporting of income and the over-claiming of expenses.<sup>60 61</sup> The extent of agreement with the under-reporting of income and the over-claiming of expenses was measured via a six-point Likert scale. Higher scores would indicate likely non-compliance behaviour and vice-versa.

**Table 3: Sources of reference for tax attitudinal variables**

<i>Variables</i>	<i>Description</i>	<i>Item Source</i>
Tax Complexity	Perception on the presence of complexity in the Malaysian tax system amongst corporate taxpayers and it was measured in relation to three dimensions comprising the complexity in income tax returns, income tax law and varying groups of taxpayers.	Christensen et al. (1994)
Tax Rate Structure	Perception on the fairness in the Malaysian corporate tax structure amongst corporate taxpayers and it was measured in relation to three rate structures: flat (Rate 1), proportional (Rate 2) and progressive (Rate 3).	Christensen et al. (1994)
Tax Deterrence Sanctions	It refers to three sanction variables, namely audit likelihood, detection likelihood and penalty severity. It was measured in relation to three dimensions, comprising respondents' perceptions on the chances of their company being audited; discrepancy being identified during compulsory tax audit and severity of penalty.	Christensen and Hite (1997)
Tax Law Fairness	Perceptions on fairness of the corporate tax system in Malaysia was measured in relation to three dimensions, which comprises respondents' perception on company officers' moral obligations, fairness under the SAS environment, and amount of taxes paid over the years.	Roberts (1994)
Tax Psychological Costs	Perceptions on the level of stress and anxiety caused by the income tax system.	Yesegat (2009)

### 3.4 Data collection

The questionnaires used in this study were validity-tested in previous studies.<sup>62</sup> Nonetheless, pre-testing using expert judges, as suggested by Hair, Black, Babin and Anderson,<sup>63</sup> was conducted in this study. This was to ensure their suitability for use in the context of Malaysian PLCs. Based on the feedback obtained from each pre-test

<sup>60</sup> The tax non-compliance scenario about the under-reporting of income (Scenario 1): 'Mr. A, a self-employed businessman is considering not disclosing a cash sale of RM100,000 as his business income in his 2009 tax return. Legally, the cash receipt of RM100,000 should be included as business income. However, he is almost certain that the tax authority will not audit him and would not know if the amount is not disclosed.'

<sup>61</sup> The tax non-compliance scenario about over-claiming of expenses (Scenario 2): 'Mr. B, a self-employed businessman, had incurred RM10,000 to repair his personal van. In preparing his 2009 tax return, he is thinking about claiming the cost of the repair as if the van was used in his business. Legally, such a claim is not allowable, but he is almost certain that he will not be audited and that the tax authority would not be able to detect the deduction.'

<sup>62</sup> See for example, Abdul-Jabbar, n 23.

<sup>63</sup> Hair JF, Black WC, Babin BJ and Anderson RE, *Multivariate data analysis: a global perspective* (7th ed, Prentice Hall, 2010).

conducted, several minor amendments (such as changing the order of questions, highlighting key terms and rewording questions) was made to improve the ease of response.

Data collection for this study utilised the researcher-administered questionnaire survey method. This method of data collection was employed as a measure to obtain more reliable survey responses with a possibility of achieving a higher response rate, thus improving the validity of this study.<sup>64</sup> In most cases, questionnaires were personally distributed to ascertain the person's willingness to participate in this study.<sup>65</sup> This arrangement also provided the opportunity for researchers to explain verbally on the importance of the study. Researchers might cautiously provide some clarifications and/or examples, when required, with respect to certain difficult, sensitive or important questions. To avoid bias in this study, however, the researchers only got involved when respondents asked for clarification. The respondents themselves inserted the completed questionnaires into sealed envelopes, in order to protect their anonymity.

#### 4. RESULTS AND FINDINGS

A total number of 101 responses were obtained, representing an overall response rate of 21.4%. However, after removing three incomplete responses, the usable response rate was 20.7%. Based on the response rate achieved in similar existing studies, and due to the small population size of listed companies, the response rate achieved by this study was considered acceptable.<sup>66</sup> Prior to data entry, all completed questionnaires were examined for missing values and the accuracy of data. Follow-up telephone calls and electronic messages were made to address missing items and to clarify matters of perceived incorrect responses. Normal probability plots and box-plots were utilised to identify outliers in the data set. The respective respondents with outlier response(s) were contacted for clarification.

##### 4.1 Respondents' profile

Based on data from 98 usable surveys, descriptive statistics of the sample were obtained in order to understand the demographic background of the respondents in this study (Table 4).

The majority of respondents involved in this study were finance and tax managers (53.1%), followed by accountants (33.7%) and chief financial officers (13.3%). The survey data acquired were considered acceptable, as the responses were obtained from persons with knowledge and experience in handling the tax matters of their respective companies. The highest response rate was gathered from respondents in the services sector (33.7%), followed by the manufacturing sector (31.6%) and the property and construction sectors (21.4%). The services and manufacturing sectors accounted for

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<sup>64</sup> Oppenheim AN, *Questionnaire design, interviewing, and attitude measurement* (St. Martin's Press, New York City, 1992).

<sup>65</sup> Data collection from 98 respondents was conducted primarily through self-administered survey. Due to time constraint, some of the questionnaires were administered via ordinary mail or e-mail.

<sup>66</sup> The usual response rates for business studies, and for international and Asian tax studies is around 10% to 20%, 25% to 35% and 14% to 26%, respectively (Abdul-Jabbar, n 23).

more than 65% of the sample population, while only one response was received from the technology sector.

**Table 4: Descriptive statistics of the sample**

<i>Items</i>	<i>Categories</i>	<i>Frequency</i>	<i>Percentage</i>
Respondents' Designation	Chief Financial Officer	13	13.3
	Finance/Tax Manager	52	53.1
	Accountant	33	33.6
Sector	Manufacturing	31	31.6
	Services	33	33.7
	Property and Construction	21	21.4
	Finance and Banking	6	6.1
	Plantation and Agriculture	6	6.1
	Technology	1	1.1
Sales Turnover (Million)	Less than MYR100	31	31.6
	MYR100 to MYR500	36	36.7
	MYR500 to MYR1,000	15	15.3
	More than MYR1,000	16	16.3
Business Length	Less than 15 years	21	21.4
	15 to 30 years	54	55.1
	More than 30 years	23	23.5
Tax Liability (Million)	Nil	9	9.2
	Less than MYR5	47	48.0
	MYR5 to MYR10	24	24.5
	More than MYR10	18	18.4
Sources of Income Tax Work	Internal only	5	5.1
	External only	24	24.5
	Internal and External	69	70.4
<b>Total</b>		<b>98</b>	<b>100.0</b>

As for the size of business, the highest response rate was from respondents in companies with an annual sales turnover level of between MYR100 million and MYR500 million (36.7%), followed by those from companies with an annual sales turnover level of less than MYR100 million (31.6%). The remaining respondents were from companies in the top two levels of annual sales turnover, with almost equal representation in each category (15.3% and 16.3%, respectively). Respondents were requested to indicate the length of time their company had been in operation. The majority of companies (55.1%) had been in operation for at least 15 years, while 23.5% had been in operation for more than 30 years. Only 21.4% of companies were in the 'Less than 15 years' category. This signifies that the sample companies had adequate experience in dealing with tax related issues. As for tax liability, 9.2% of companies had a nil tax liability for the year of assessment 2009. Nearly one-half of companies (48%) indicated their tax liability to be less than MYR5 million.

With respect to sources of income tax work, some companies handled their tax affairs internally, some completely outsourced their tax-related activities and a large proportion of corporate taxpayers made use of both sources. Almost 95% of the respondent companies employed external tax professionals, while more than 70%

utilised both internal resources and external tax professionals to deal with their income tax matters. Twenty-four companies completely outsourced their tax-related activities, while only five companies were very dependent on their internal tax expertise.

Overall, reasonable variations were seen in corporate characteristics such as industry classification, annual sales turnover, length of time in business, tax liability and sources of income tax work.

## 4.2 Descriptive analysis of the variables

This section provides descriptive analysis of the variables of this study, namely tax compliance costs, tax attitudinal aspects and tax compliance behaviour.

## 4.3 Tax compliance costs

The estimation of tax compliance costs for each company was the summation of its measurable internal, external and incidental cost components. The estimates of tax compliance costs at the company level ranged widely, from a low of MYR10,506 (AUD3,420)<sup>67</sup> to a high of MYR155,790 (AUD50,713), with a mean of MYR47,126 (AUD15,340). The largest share of estimated mean compliance costs by cost component was related to external costs (57.1%), followed by internal costs (38.2%). Only a small portion (4.7%) was related to incidental costs in complying with tax laws. The overall mean compliance cost for each company by cost component was MYR55,886 (AUD18,192).

## 4.4 Tax attitudinal aspects

Concerning the tax attitudinal variable, each aspect was analysed using the mean, median and standard deviation scores (Table 5). Perceptions of tax psychological costs yielded the highest mean (3.96), followed by tax law fairness (3.87), tax complexity (3.53), tax rate structure (3.15) and lastly, tax deterrence sanctions (2.98). Fairness in the tax rate structure was perceived to be marginally fair, while tax deterrence sanctions (audit likelihood, deterrence likelihood and penalty severity) were perceived to be marginally low. A Cronbach's alpha value of between 0.699 and 0.899 (Table 5) indicates that the measurements employed in this study are reliable and consistent. The Alpha Coefficient values of 0.60 to 0.70 are deemed to be at the lower limit of acceptability.<sup>68</sup>

In assessing construct validity, a factor analysis conducted using a rotated component matrix supported the four subscales of tax attitudinal aspects: tax complexity, tax rate structure, tax deterrence sanctions and tax law fairness (Table 6). The Kaiser-Meyer-Olkin (KMO) Statistic was 0.648, suggesting that sampling in the current study was adequate. Bartlett's Test of Sphericity was highly significant ( $p=0.00$ ), indicating that factor analysis was appropriate for these survey data. A KMO value of greater than 0.5 and the significant result indicated that the construct validity of each statement and the

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<sup>67</sup> AUD1 = MYR3.072 (2 January 2010, Central Bank of Malaysia)  
<http://www.bnm.gov.my/index.php?tpl=exchangerates>

<sup>68</sup> Hair, Black, Babin and Anderson, n 63.

related components within each construct were significantly correlated. This is required for results of factor analysis to be acceptable.<sup>69</sup>

**Table 5: Perceptions towards tax attitudinal aspects**

<i>Attitudinal Aspect</i>	<i>Mean</i>	<i>Median</i>	<i>Standard Deviation</i>	<i>Number of items</i>	<i>Cronbach's alpha</i>
Tax Complexity	3.53	3.67	1.25	3	0.899
Tax Rate Structure	3.15	3.00	1.24	3	0.760
Tax Deterrence Sanctions <sup>a</sup>	2.98	3.00	0.96	3	0.699
Tax Law Fairness <sup>a</sup>	3.87	4.00	0.88	3	0.786
Tax Psychological Costs	3.96	4.00	1.16	1	-

<sup>a</sup>One item of each aspect was taken out to get an acceptable alpha coefficient.

**Table 6: Rotated component matrix for factor analysis**

<i>Variable Name</i>	<i>Tax Attitudinal Aspect</i>			
	<i>Complexity</i>	<i>Rate Structure</i>	<i>Sanctions</i>	<i>Fairness</i>
Complex 1	0.834			
Complex 2	0.847			
Complex 3	0.801			
Rate 1		0.852		
Rate 2		0.423		
Rate 3		0.890		
Sanction 2			0.703	
Sanction 3			0.569	
Sanction 4			0.660	
Fair 2				0.889
Fair 3				0.904
Fair 4				0.638

Extraction Method: Principal Component Analysis; Rotation method: Varimax with Kaiser Normalization

## 4.5 Tax non-compliance behaviour

The views of respondents on the full and partial non-compliance behaviour of corporate taxpayers are provided in Table 7. The extent of agreement on full and partial under-reporting of income and over-claiming of expenses was measured via a six-point Likert scale.<sup>70</sup> Regarding the under-reporting of income, a mean score of

<sup>69</sup> Field A, *Discovering statistics using SPSS* (2<sup>nd</sup> ed, SAGE Publications, London Thousand Oaks New Delhi, 2005).

<sup>70</sup> An analysis was also undertaken to measure partial non-compliance behaviour. Respondents' partial non-compliance behaviours were investigated by eliciting responses on the likelihood of them not complying with only part of the amount stated for both scenarios. Scenario 1: 'Taking into account all known and likely business circumstances, to what extent do you agree with Mr. A's possible action of not reporting that cash sale of RM100,000 as his business income?'. Scenario 2: 'Taking into account

1.98 indicated the strong disagreement of respondents with this non-compliance behaviour. Comparatively, for the over-claiming of expenses, the mean score was slightly higher (2.61). Nevertheless, an overall mean of 2.30 for the under-reporting of income and over-claiming of expenses is an indication of marginally compliant behaviour among corporate taxpayers. The mean score of the respondents' views towards partial non-compliance behaviour for both scenarios was higher, compared to the findings of full compliance behaviour. An overall mean score of 3.28 provided some indication of marginally non-compliant behaviour.

**Table 7: Respondents' views towards non-compliance behavior**

<i>Tax Compliance Behaviour</i>	<i>Full</i>			<i>Partial</i>		
	<i>Mean</i>	<i>Median</i>	<i>SD</i>	<i>Mean</i>	<i>Median</i>	<i>SD</i>
Under-reporting of income	1.98	1.00	1.33	3.38	4.00	1.63
Over-claiming of expenses	2.61	2.00	1.56	3.18	3.00	1.67
Overall non-compliance	2.30	2.00	1.34	3.28	3.50	1.40

#### 4.6 Determinants of tax compliance behaviour

The objective of this study is to gain insight into the influence of some possible causes that affect the compliance behaviour of taxpayers. It is stated as follows: "To examine the relationship between corporate characteristics, tax compliance costs, tax attitudinal aspects and compliance behaviour of taxpayers." Multiple regression analysis was utilised to identify the determinants of the tax non-compliance behaviour of PLCs. The predictor variables for the regression analyses were corporate characteristics (size, sector, year, and tax), tax compliance costs, and tax attitudinal aspects (complexity, rate, sanctions, fairness and psychological costs). Assessments of the four assumptions underlying the regression analysis, namely, normality, linearity, homoscedasticity and multicollinearity, revealed that no assumptions for multiple regressions were violated.

Three regression analyses were carried out separately to identify the likely tax non-compliance behaviour of corporate taxpayers (Table 8). All regressions were found to be statistically significant at the one per cent level: (1) under-reporting of income, (2) over-claiming of expenses and (3) overall non-compliance behaviour.

##### 4.6.1 Under-reporting of income

The predictor variables explained 38% of the variability in the non-compliance behaviour of corporate taxpayers ( $F=5.804$ ,  $p<0.01$ ). Eight variables were found to be significant determinants of tax non-compliance behaviour in terms of the under-reporting of income. The predictors include business size [medium-sized PLCs ( $t=2.386$ ,  $p<0.05$ ), large-sized PLCs ( $t=1.938$ ,  $p<0.10$ )], tax liability ( $t=-3.420$ ,  $p<0.01$ ), business age ( $t=-3.612$ ,  $p<0.01$ ), tax complexity ( $t=2.697$ ,  $p<0.01$ ), tax rate structure ( $t=1.882$ ,  $p<0.10$ ), tax deterrence sanctions ( $t=-2.370$ ,  $p<0.05$ ) and tax psychological costs ( $t=4.847$ ,  $p<0.01$ ). Companies with a higher annual sales turnover, shorter business age and those with a lower tax liability were more non-compliant.

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*all known and likely business circumstances, to what extent do you agree with Mr. B's possible action of claiming RM10,000 as his business deduction?'*

**Table 8: Estimates of coefficient results summary of multiple regressions**

Regression <sup>a</sup>	<i>Under-reporting of Income</i>		<i>Over-claiming of Expenses</i>		<i>Overall Non-compliance</i>	
	$\beta^b$	<i>t-value</i>	$\beta^b$	<i>t-value</i>	$\beta^b$	<i>t-value</i>
Constant	4.454	2.780	5.166	2.317	4.810	2.787
Size (Medium-sized PLC) <sup>c</sup>	0.685	2.386**	0.639	1.598	0.662	2.140**
Size (Large-sized PLC) <sup>c</sup>	0.691	1.938*	0.393	0.793	0.542	1.412
Sector (Manufacturing) <sup>d</sup>	-0.431	-1.514	-0.640	-1.613	-0.535	-1.744*
Sector (Other) <sup>d</sup>	0.185	0.617	0.463	1.107	0.324	1.001
Tax (Tax Liability)	-0.901	-3.420***	-0.699	-1.908*	-0.800	-2.820***
Year (Business Length)	-0.035	-3.612***	-0.045	-3.384***	-0.040	-3.862***
Cost (Tax Compliance Costs)	-0.339	-0.873	-0.844	-1.561	-0.592	-1.414
Complex (Tax Complexity)	0.288	2.697***	0.322	2.168**	0.305	2.652**
Rate (Tax Rate Structure)	0.199	1.882*	-0.168	-1.141	0.016	0.137
Sanction (Tax Deterrence Sanctions)	-0.322	-2.370**	-0.257	-1.362	-0.290	-1.980*
Fair (Tax Law Fairness)	-0.109	-0.753	0.447	2.220**	0.169	1.084
Psycho (Tax Psychological Costs)	0.571	4.847***	0.178	1.086	0.375	2.952***
R <sup>2</sup>		0.459		0.296		0.385
Adjusted R <sup>2</sup>		0.380		0.193		0.295
Standard Error		1.053		1.465		1.134
F-value		5.804		2.873		4.284
P-value		0.000***		0.002***		0.000***

Notes: <sup>a</sup>Regression: Under-reporting of Income Over-claiming of Expenses Overall Non-compliance

<sup>b</sup>Unstandardized Coefficient

<sup>c</sup>The four levels of annual sales turnover were reclassified into three levels (small, medium and large) due to low number of responses in the last two categories. For regression purposes, two dummy variables were created with a sales turnover level of less than MYR100 million (small-sized PLC) as the reference level. <sup>d</sup>The six industry sectors were reduced to three sectors namely, manufacturing, services and 'others', due to low number of responses in certain sectors. 'Others' include the remaining sectors namely 'property & construction', 'finance & banking', 'plantation & agriculture' and 'technology'. Two dummy variables were created with 'services' as the reference sector. \*\*\* *p*-Value < 1% with two-tailed tests; \*\* *p*-Value < 5% with two-tailed tests; \* *p*-Value < 10% with two-tailed tests.

With other variables held constant, non-compliance behaviours were positively related to company size while negatively related to business age and tax liability. The results further indicated that non-compliance with respect to the under-reporting of income was greater for companies with a higher perceived tax complexity level, and higher perceived level of fairness in the tax rate structure.<sup>71</sup> Non-compliance was lower, however, for companies with higher perceived tax deterrence sanctions. The findings also suggested that companies with higher psychological costs tended to be more non-compliant.

#### *4.6.2 Over-claiming of expenses*

When it came to the over-claiming of expenses, the regression was a rather poor fit. The adjusted R<sup>2</sup> was merely 19.3%, but the overall relationship was significant ( $F=2.873$ ,  $p<0.01$ ). Only four variables were found to be significant determinants of the non-compliance behaviour of corporate taxpayers. The predictors were tax liability ( $t=-1.908$ ,  $p<0.10$ ), business age ( $t=-3.384$ ,  $p<0.01$ ), tax complexity ( $t=2.168$ ,  $p<0.05$ ) and tax fairness ( $t=2.220$ ,  $p<0.05$ ). With other variables held constant, non-compliance behaviour was negatively related to tax liability and business age. Companies with a lower tax liability and those with shorter business age were more non-compliant. The result also signified that non-compliance was greater for companies with a high perceived tax complexity level and perception of fairness in the tax rate structure.

#### *4.6.3 Overall non-compliance*

The predictor variables explained almost 30% of the variability in the overall non-compliance behaviour of corporate taxpayers.<sup>72</sup> Business size ( $t=2.140$ ,  $p<0.05$ ), business sector ( $t=-1.744$ ,  $p<0.10$ ), tax liability ( $t=-2.820$ ,  $p<0.01$ ), business age ( $t=-3.862$ ,  $p<0.01$ ), tax complexity ( $t=2.652$ ,  $p<0.05$ ), tax deterrence sanctions ( $t=-1.980$ ,  $p<0.10$ ) and tax psychological costs ( $t=2.952$ ,  $p<0.01$ ) were found to be significant determinants of corporate non-compliance behaviour. Medium-sized PLCs with annual sales turnover of between MYR100 million and MYR500 million were found to be more likely to demonstrate non-compliance behaviour. Companies in the manufacturing sector were identified as being more compliant compared to those in the other sectors. The finding also indicated that non-compliance behaviour was greater for companies with a lower tax liability, shorter business age, a high-perceived tax complexity level and low perceived tax deterrence sanctions. Companies with higher psychological costs tended to be more non-compliant with respect to overall non-compliance behaviour.

The evaluation of research hypotheses formulated to identify the determinants of tax compliance behaviour for this study has been summarised (Table 9).

Hypothesis 1 (**H<sub>1</sub>**) posited that there is a relationship between the tax compliance costs incurred by corporate taxpayers and their non-compliance behaviour. However, the results of the regression analyses undertaken indicate insignificant relationships between tax compliance costs and all three types of tax non-compliance behaviour. Thus, **H<sub>1</sub>** is not supported. This lack of relationship may be explained by the fact that

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<sup>71</sup> The respondents to this study are PLCs hence their perception on fairness of the corporate tax system might differ from earlier studies that focus on individual taxpayers and SMEs.

<sup>72</sup> Overall non-compliance is a combination of two types of tax non-compliance behaviour: the under-reporting of income and the over-claiming of expenses.



**Table 9: Summary of Hypotheses Evaluation**

Construct	Hypotheses Statement		Outcome	Regression
Tax Compliance Costs	H <sub>1</sub> :	A reduction in tax compliance costs reduces the level of non-compliance among corporate income taxpayers.	Not Supported	-
Corporate Characteristics	H <sub>2a</sub> :	There is a relationship between business size and non-compliance of corporate taxpayers.	Supported	<ul style="list-style-type: none"> <li>▪ Under-Reporting of Income</li> <li>▪ Overall Non-Compliance</li> </ul>
	H <sub>2b</sub> :	There is a relationship between business sectors and non-compliance of corporate taxpayers.	Supported	<ul style="list-style-type: none"> <li>▪ Overall Non-Compliance</li> </ul>
	H <sub>2c</sub> :	There is a relationship between business length and non-compliance of corporate taxpayers.	Supported	<ul style="list-style-type: none"> <li>▪ Under-Reporting of Income,</li> <li>▪ Over-Claiming of Expenses</li> <li>▪ Overall Non-Compliance</li> </ul>
	H <sub>2d</sub> :	There is a relationship between business tax liability and non-compliance of corporate taxpayers.	Supported	<ul style="list-style-type: none"> <li>▪ Under-Reporting of Income</li> </ul>
Tax Attitudinal Aspects	H <sub>3a</sub> :	There is a relationship between perceived tax complexity and non-compliance of corporate taxpayers.	Supported	<ul style="list-style-type: none"> <li>▪ Under-Reporting of Income</li> <li>▪ Over-Claiming of Expenses</li> <li>▪ Overall Non-Compliance</li> </ul>
	H <sub>3b</sub> :	There is a relationship between perceived tax deterrence sanctions and non-compliance of corporate taxpayers.	Supported	<ul style="list-style-type: none"> <li>▪ Under-Reporting of Income</li> <li>▪ Overall Non-Compliance</li> </ul>
	H <sub>3c</sub> :	There is a relationship between perceived fairness in the tax rate structure and non-compliance of corporate taxpayers.	Supported	<ul style="list-style-type: none"> <li>▪ Under-Reporting of Income</li> </ul>
	H <sub>3d</sub> :	There is a relationship between perceived fairness of the tax system and non-compliance of corporate taxpayers.	Supported	<ul style="list-style-type: none"> <li>▪ Over-Claiming of Expenses</li> </ul>
	H <sub>3e</sub> :	There is a relationship between perceived level of psychological costs and non-compliance of corporate taxpayers.	Supported	<ul style="list-style-type: none"> <li>▪ Under-Reporting of Income</li> <li>▪ Overall Non-Compliance</li> </ul>

this study focused only on PLCs. Based on the findings of existing studies, business size was found to be a significant determinant of tax non-compliance behaviour in studies covering small, medium and large-sized corporations, but not in studies targeting a homogenous group of corporate taxpayers.<sup>73</sup>

Hypothesis 2 (**H<sub>2</sub>**) predicted that there is a relationship between corporate characteristics and tax non-compliance behaviour. The results indicate full support for tax liability and business age, but partial support for business sector and size across the non-compliance categories. Business size (**H<sub>2a</sub>**) is a significant determinant of the under-reporting of income and overall non-compliance. Medium-sized PLCs with annual sales turnover of between MYR100 and MYR500 million were observed to be more non-compliant than small-sized PLCs.<sup>74</sup> To a lesser extent, larger PLCs were more non-compliant than the smaller PLCs. The business sector (**H<sub>2b</sub>**) characteristic was only a significant determinant of overall non-compliance, while PLCs in the manufacturing sector were more compliant than those in the services sector. This study provides evidence of the significant influence of business age (**H<sub>2c</sub>**) and tax liability (**H<sub>2d</sub>**) on all the three types of taxpayer non-compliance behaviour. In terms of business age, the possibility of non-compliance decreased the longer a PLC had been in operation. It is inferred that companies that have been in operation longer are more compliant than their younger counter-parts. With respect to corporate tax liability, the possibility of non-compliance decreased with the increase in the tax liability.<sup>75</sup> This finding implies that PLCs with a lower tax liability tend to be more non-compliant. This could be interpreted as PLCs are either not disclosing all income or are over claiming expenses.

Hypothesis 3 (**H<sub>3</sub>**) is well supported, as the findings indicated that tax complexity, tax rate structure, tax deterrence sanctions, tax law fairness and tax psychological costs had a significant relationship with at least one type of non-compliance behaviour. Tax complexity (**H<sub>3a</sub>**) was found to have a significant relationship with tax non-compliance behaviour for all types of non-compliance. Findings showed that higher perceptions of complexity surrounding the CIT system resulted in greater non-compliance among corporate taxpayers. The perception of tax deterrence sanctions (**H<sub>3b</sub>**) was a significant determinant of the under-reporting of income and overall non-compliance. Increases in tax deterrence sanctions pertaining to audit likelihood, detection likelihood and the severity of penalties resulted in lower non-compliance among PLCs. There is a significant relationship between perceived fairness in the tax rate structure (**H<sub>3c</sub>**) and the under-reporting of income, as well as between the perception of fairness of the tax system (**H<sub>3d</sub>**) and the over-claiming of expenses. Finally, perceptions of the level of tax psychological costs (**H<sub>3e</sub>**) were significant determinants of the under-reporting of income and overall non-compliance. The possibility of non-compliance increased with the level of tax psychological costs. Companies with higher psychological costs, in terms of stress and anxiety in meeting their compliance obligations, tended to be more non-compliant.

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<sup>73</sup> Another possible explanation may be due to the regressive nature of tax compliance cost, which suggests that large companies may not feel the tax burden as much as smaller companies.

<sup>74</sup> For regression purposes, small PLCs with a sales turnover level of less than MYR100 million is selected as the reference level.

<sup>75</sup> The amount of tax liability is based on estimated tax liability for some companies, as the timing of this study may not permit the determination of actual tax liabilities. The actual tax liability will only be available within a six-month period after the end of accounting period when the company is required to submit the tax return to IRBM.

## 5. CONCLUSION

The findings in this study enhance the tax compliance literature in terms of the factors that are likely to influence the tax non-compliance of corporate taxpayers. Specifically, this study provides an empirical evaluation of the determinants of corporate tax non-compliance behaviour, namely, tax compliance costs, corporate characteristics and tax attitudinal aspects. While most existing studies examined the determinants of tax compliance behaviour in general, this study took the approach a step further by observing different types of non-compliance behaviour: the under-reporting of income, the over-claiming of expenses and overall non-compliance.

The overall conclusions from this study's research findings on the tax compliance behaviour of corporate taxpayers are broadly in line with existing studies in this area. This study confirms that tax complexity is an important determinant of corporate taxpayer compliance.<sup>76</sup> Concerning business size, this study found it to be a significant determinant of tax non-compliance behaviour.<sup>77</sup>

The findings of this study therefore add to the research evidence from countries in emerging economies, which tend to have weaker tax policy structures and less transparent tax systems than the advanced economies.<sup>78</sup>

Issues related to tax compliance behaviour are of interest to policy makers in the area of taxation, as well as to the taxation profession and corporate management. Information gathered from this study can assist the government, particularly the tax authorities, when formulating future tax policies. The findings of this study indicate that taxpayer compliance could be improved further mainly by enhancing the positive attitudes of taxpayers towards the psychological costs and complexity of the tax system. Apart from simplifying the tax system, the IRBM should consider improving its public relations strategies and developing a more comprehensive taxpayer charter, as has been practiced in most advanced economies.

This study is not without its limitations, and many of them represent opportunities for future research. In this study, corporate taxpayer attitudes and compliance behaviour were measured from the managerial or respondent's perspective. Joulfaian introduced the concept of managerial preferences as a proxy to measure compliance behaviour of corporation.<sup>79</sup> As the respondents were persons, not the company itself, they might not necessarily represent the attitudes and behaviour of the PLCs being studied. Another limitation is the use of hypothetical tax scenarios and the respective monetary amount in determining taxpayer compliance behaviour. It is recognised that the actual judgement of the respondents may vary and that the findings would depend considerably on their honesty. Nevertheless, as most corporations would have strong incentives to avoid revealing their non-compliance decisions, any direct measures will

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<sup>76</sup> In the context of individual taxpayers, see Cuccia AD, n 9 and McKerchar M, *The impact of complexity upon unintentional non-compliance for Australian personal income taxpayers* (Unpublished doctoral dissertation, ATAX, University of New South Wales, Sydney, Australia, 2002). In the context of SMEs see Abdul-Jabbar, n 23

<sup>77</sup> This finding is consistent with the findings of Joulfaian, n 11 and Hanlon, Mills and Slemrod, n 11, but it contradicts the findings of Rice, n 17 and Abdul-Jabbar, n 23. A possible reason for differences in research findings may be due to studies targeting different company sizes and/or adopting varying size measures

<sup>78</sup> Ariff M and Pope J, *Taxation and compliance cost in Asia Pacific economies* (University Utara Malaysia Press, Sintok, 2002).

<sup>79</sup> Joulfaian, n 11

invariably suffer from substantial measurement errors (Rice, 1992).<sup>80</sup> As such, it should be acknowledged that these challenges are the limitations of this study.

Future research should consider conducting in-depth interviews as a complement to surveys, as they would be useful in providing a deeper understanding and explanation of the relationship between the variables. The use of case studies may provide better quality responses to some issues of interest, including probing the impact of lower compliance costs on compliance decisions. Future studies might consider the use of the experimental method, where the non-compliance behaviour of taxpayers is measured through a controlled experiment.<sup>81</sup> Future studies may also consider other specific types of non-compliance behaviour, such as failure to submit a tax return and/or failure to remit taxes by the due date.<sup>82</sup>

Dealing with taxation matters, particularly in emerging economies, remains a challenge due to limited awareness, administrative flaws and a lack of government commitment to enforcing tax laws. This study has systematically identified, and analysed the areas that deserve due attention, focusing in this case on the compliance behaviour of corporate-taxpayers. To this end, the findings of this study have made a significant contribution to the body of tax knowledge, as well as to tax policy makers charged with devising specific measures to enhance voluntary compliance.

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<sup>80</sup> Rice, n 17.

<sup>81</sup> Trivedi VU, Shehata M and Mestel-Man S, "Attitudes, incentives and tax compliance" (2005) 53(1) *Canadian Tax Journal* 29-30.

<sup>82</sup> See Baldry J and Kasipillai J, "Malaysia: Income tax enforcement" 1996 2(9) *Asia-Pacific Tax Bulletin* 268-72.

## APPENDIX: QUESTIONNAIRE

### Determinants of Tax Compliance Behavior of Corporate Taxpayers in Malaysia

#### SECTION A: TAX COMPLIANCE COSTS

Kindly fill in an approximate estimated time, monetary amount and/or breakdown of the following internal costs of complying with corporate income tax:

1. How much **time** within the company was spent entirely on additional or exclusive work for company income tax purposes for 2009?

	No. of Staff	Total hours/ month
Finance Director; Chief Financial Controller/Officer	<input type="text"/>	<input type="text"/>
Accountant / Tax Manager	<input type="text"/>	<input type="text"/>
General / Non-Financial Manager	<input type="text"/>	<input type="text"/>
Accounting Staff	<input type="text"/>	<input type="text"/>
Other (please state) _____	<input type="text"/>	<input type="text"/>

2. Does your company incur any other **additional non-staff costs** in meeting the income tax requirements for the year of assessment 2009? (*For example: Stationery, postage and travelling*)

☐ No, continue to Question 3      ☐ Yes, please respond to the following question:

Please estimate the additional costs involved in 2009:

MYR

3. Does your company employ **external tax professionals** to handle income tax matters in 2009?

☐ Yes, please continue to Question 8      ☐ No, please go to Question 6 (Section B)

4. The **source** of external advice were:

(Please tick: if more than one, please rank in order of importance using 1 as most important).

	Tick	Rank
Professional Accountants	<input type="checkbox"/>	<input type="text"/>
Tax agents	<input type="checkbox"/>	<input type="text"/>
Inland Revenue Board (IRB)	<input type="checkbox"/>	<input type="text"/>
Other (please state) _____	<input type="checkbox"/>	<input type="text"/>

5. Please provide or estimate the **external tax fees** incurred by your company for the corporate income tax activities in the financial year 2009:

MYR

## SECTION B: PERCEPTIONS AND OPINIONS

6. Kindly respond to the following statements to indicate your **opinion** to each of the statements. There are no right and wrong answers. *(Please tick one box on a 6 point scale for each statement.)*

	LEVEL OF IMPORTANCE							
Personally, I consider that the preparation of corporate income tax return is difficult.	Strongly agree	⑥	⑤	④	③	②	①	Strongly disagree
Corporate income tax law is relatively simple to understand.	Strongly agree	⑥	⑤	④	③	②	①	Strongly disagree
Complexity in tax law is necessary so that companies are treated fairly.	Strongly agree	⑥	⑤	④	③	②	①	Strongly disagree
A 'fair' tax rate should be the same for every company regardless of their size (small, medium or large).	Strongly agree	⑥	⑤	④	③	②	①	Strongly disagree
Large companies have a greater ability to pay income tax, so it is fair that they should pay a higher rate of tax than small and medium companies.	Strongly agree	⑥	⑤	④	③	②	①	Strongly disagree
It is fair that high profit companies should pay a higher rate of tax than low profit companies.	Strongly agree	⑥	⑤	④	③	②	①	Strongly disagree
If there was a discrepancy in the annual tax return, how likely is that it would be audited?	Very Likely	⑥	⑤	④	③	②	①	Very Unlikely
If your company was to be chosen for compulsory audit, how likely would a discrepancy be identified?	Very Likely	⑥	⑤	④	③	②	①	Very Unlikely
If discrepancies were discovered during an audit, how severe are the penalties?	Very Severe	⑥	⑤	④	③	②	①	Not Very Severe
The chances of being audited (tax audit) are so low that it is worthwhile trying to economize a little on corporate income taxes for various reasons.	Strongly agree	⑥	⑤	④	③	②	①	Strongly disagree
I believe that each company's officers have a moral obligation to report all of their company's income and pay the correct amount of corporate income tax.	Strongly agree	⑥	⑤	④	③	②	①	Strongly disagree
Do you believe that the move to self-assessment made corporate tax laws more or less fair?	Much more fair	⑥	⑤	④	③	②	①	Much less fair
Overall, has the move to self-assessment made the distribution of the corporate income tax burden among small, medium and large companies more or less fair?	Much more fair	⑥	⑤	④	③	②	①	Much less fair
Do you believe that as a result of changes in corporate income tax during the past five years, large companies are paying more or fewer taxes?	Much more taxes	⑥	⑤	④	③	②	①	Much fewer taxes
The tax compliance requirement may have caused stress and anxiety to taxpayers. Indicate your position with respect to the psychological costs caused by the income tax system.	Very Stressful	⑥	⑤	④	③	②	①	Not Very Stressful

**SECTION C: COMPLIANCE BEHAVIOUR**

7. Read the following and kindly indicate your opinion (by way of a tick) to the following scenario based on your experience:

Mr A, a self-employed businessman is considering not disclosing a cash sale of MYR100,000 as his business income in his 2009 tax return. Legally, the cash receipts of MYR100,000 should be included as a business income. However, he is almost certain that the tax authority will not audit him and would not know if the amount is not disclosed.

- (a) Taking into account all known and likely business circumstances, to what extent do you agree with Mr A's possible action of not reporting that cash sale of MYR100,000 as his business income?

Strongly agree	⑥	⑤	④	③	②	①	Strongly disagree
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- (b) Would he be likely to report only part of the MYR100,000 as business income?

Very Likely	⑥	⑤	④	③	②	①	Very Unlikely
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8. Read the following and kindly indicate your opinion (by way of a tick) to the following scenario based on your experience:

Mr B, a self-employed businessman, had incurred MYR10,000 to repair his personal van. In preparing his 2009 tax return, he is thinking about claiming the costs of repair as if the van was used in his business. Legally, such claim is not allowable, but he is almost certain that he will not be audited and that the tax authority would not be able to detect the deduction.

- (a) Taking into account all known and likely business circumstances, to what extent do you agree with Mr B's possible action of claiming MYR10,000 as his business deduction?

Strongly agree	⑥	⑤	④	③	②	①	Strongly disagree
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- (b) Would he be likely to deduct only part of the MYR10,000 as a business deduction?

Very Likely	⑥	⑤	④	③	②	①	Very Unlikely
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**SECTION D: GENERAL INFORMATION AND SUGGESTIONS**

*Kindly tick the most appropriate responses or fill in the appropriate details in the space provided.*

9. What is your company main business **activity**?

- |  |  |
|--|--|
| <input type="checkbox"/> Manufacturing             | <input type="checkbox"/> Plantation and Agriculture  |
| <input type="checkbox"/> Services                  | <input type="checkbox"/> Finance and Banking         |
| <input type="checkbox"/> Property and Construction | <input type="checkbox"/> Others (please state) _____ |

10. What was the **turnover** of the company in 2009:

- |  |  |
|--|--|
| <input type="checkbox"/> Less than MYR100 million      | <input type="checkbox"/> MYR500,000,001–MYR1,000,000,000 |
| <input type="checkbox"/> MYR100,000,000–MYR500,000,000 | <input type="checkbox"/> More than MYR1,000 million      |

11. How much company **income tax** in total, in relation to the 2009 year of income did the company remit to the Malaysian Inland Revenue Board?

- |   |   |
|---|---|
| <input type="checkbox"/> Nil (no tax liability) | <input type="checkbox"/> Between MYR5 million and MYR10 million |
| <input type="checkbox"/> Less than MYR5 million | <input type="checkbox"/> More than MYR10 million                |

12. The **period** your company has been in business is: \_\_\_\_\_ years.

**Thank you for taking time to participate in this survey.**

***Confidentiality***

*The views expressed in the completed questionnaire will be treated in the strictest confidence. Any information identifying the respondents will not be disclosed.*



# Paying a fair share of tax and aggressive tax planning — A tale of two myths

Kalmen Hyman Datt<sup>1</sup>

## ***Abstract***

This article critically evaluates calls by the Australian Taxation Office (ATO) for directors of corporations to ensure companies pay a ‘fair share of tax’ or act as a ‘good corporate citizen’ or not embark on ‘aggressive tax planning’ schemes. The author concludes the first two terms mean whatever the speaker wishes them to mean and introduce an emotive and subjective element into the determination of a company’s tax liability. Although tax regulators have attempted to define what is meant by ‘aggressive tax planning’ this too suffers from the above criticisms. This latter phrase does not tell the reader/listener how to identify ‘aggressive tax planning’. Either a scheme can be successfully challenged by the regulator or it cannot. If the latter, irrespective of the descriptors used, it is legal and unobjectionable. The author suggests the Commissioner should refrain from using these terms.

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<sup>1</sup> The author is a senior lecturer in the School of Taxation and Business law, UNSW, Australia. This article forms part of the research conducted by the author for a PhD.

## 1. INTRODUCTION

This article, although directed primarily at the Australian tax system has application to all jurisdictions where the regulator calls on directors to ensure corporations pay a ‘fair share of tax’ or act as a ‘good corporate citizen’ or not embark on ‘aggressive tax planning’ schemes. This article critically evaluates these calls. No meaning can be ascribed to the first two terms. All the phrases convert what should be an objective determination of liability for tax into an emotive subjective concept with political overtones. These statements may also be a call to pay more tax than the law requires. If this latter view is correct the Commissioner has no power to make such calls as their effect would be to impose a tax or increase the rate of taxation beyond that prescribed by Parliament. These phrases may also be calls for directors to breach their corporations’ law obligations.

The scheme of this article is as follows: Section two briefly reviews the obligation of directors imposed by the *Corporations Act* 2000 (Cth) (*Corporations Act*) with reference to tax. Although having relevance to all taxes imposed by Parliament this article only deals with Federal income tax. Section 3 critically evaluates the phrases pay a ‘fair share of tax’ or to act as a ‘good corporate citizen.’ Consideration is also given to a related topic namely corporate social responsibility (CSR). Section 4 critically analyses the call by the ATO not to embark on ‘aggressive tax planning’. Section 5 sets out the author’s conclusions.

The next section considers the obligations of directors in relation to tax. The first part deals with the obligation of directors to act in the best interests of the corporations. The next part considers the duties of care, good faith and diligence. Part three reviews the overarching duty of taxpayers to pay such taxes as the law prescribes.

## 2. THE OBLIGATION OF DIRECTORS

### 2.1 The primary obligation

There are numerous cases that state that directors must act for the benefit of the company.<sup>2</sup> This is reinforced by the *Corporations Act*, which require directors to act in good faith and in the best interests of the company.<sup>3</sup>

Van Der Linde states “[t]he focus of directors’ duties remains the company as a whole, translating into the maximisation of shareholder value”.<sup>4</sup> The derivation and maximisation of profits is important because generally, without profits few, if any, of

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<sup>2</sup> Examples include, *Harlowe’s Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483; *Smith Kline & French Laboratories Ltd v Inter-Continental Pharmaceuticals (Australia) Pty Ltd* (1969) 123 CLR 514; *Kalls Enterprises Pty Ltd (In Liq) v Baloglow* [2007] NSWCA 191 (24 October 2007).

<sup>3</sup> *Corporations Act* s 181 (1).

<sup>4</sup> Kathleen Van Der Linde, ‘The Personal Liability of Directors for Corporate Fault—An Exploration’ (2008) 20 *SA Mercantile Law Journal* 439, 439–440.

the goals of the corporation can be achieved. The predominant way of measuring success is the level of post-tax profits derived by a company. Tax must be calculated and accurately reflected in companies' financial statements.<sup>5</sup> The greater the profit derived by a company, the greater the ability of the company to achieve its goals and act for the benefit of its shareholders and other stakeholders. A loss-making company is generally unable to pay dividends and loses value. In the past corporations could only pay dividends from profits but since the incorporation of section 254T into the *Corporations Act* in 2010 corporations can now pay dividends if: the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend; the payment of the dividend is fair and reasonable to the company's shareholders as a whole; and the payment of the dividend does not materially prejudice the company's ability to pay its creditors.<sup>6</sup>

Tax is an unavoidable expense of the company in its search for profits and directors need to devote time to formulating tax strategies both to ensure a corporation complies with its tax obligations and to limit its liability for tax. Corporations generally strive to achieve a competitive effective tax rate. Owens states:

So what are the aims of the tax directors today? Clearly, an overriding objective continues to be to minimise tax liabilities so as to produce a competitive effective tax rate. But this desire to minimise tax will normally be tempered by the need to achieve a stable and sustainable tax rate. Achieving this should reduce the amount of time that senior management has to spend on resolving tax disputes with the revenue bodies.<sup>7</sup>

Not everyone holds that a lower effective tax rate is advantageous. Thomas and Zhang contend that, although a tax expense is deducted from pre-tax profit when computing net income, it is essentially a proxy for underlying profitability; as such, unexpected increases in tax expense are good news.<sup>8</sup> If the increase in tax is supported by an increase in profits, this view seems correct. However, if the increase in tax is not accompanied by an increase in profits, and is not owing to a change in the tax laws, this may be cause for concern and may indicate the directors are not acting in accordance with their common law and statutory obligations.

If there is any conflict (other than in insolvency) between the interests of the corporations and the interests of shareholders or other stakeholders, the interests of the company take precedence. The Supreme Court of Canada, in a unanimous judgment in *BCE*, state:

The fiduciary duty of the directors to the corporation originated in the common law. It is a duty to act in the best interests of the corporation. Often the interests of shareholders and stakeholders are co-extensive with the

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<sup>5</sup> For example, the Australian Accounting Standards Board, 'Standard AASB112' (2012) Items 12 and 15 deal with how corporations' financial statements must reflect tax.

<sup>6</sup> *Corporations Act* s254T (1) (a) to (c).

<sup>7</sup> Jeffrey Owens, 'Keynote Address' (Speech delivered at the Tax Executives Institute Conference, Washington DC, 19 March 2007).

<sup>8</sup> Jacob Thomas and Frank Zhang, 'Valuation of Tax Expense' (2010) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1464162](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1464162)>.

interests of the corporation. But if they conflict, the directors' duty is clear—it is to the corporation.<sup>9</sup>

Australian common law has the same principle.<sup>10</sup>

It follows that tax minimisation policies that do not breach the anti-avoidance rules should be considered and adopted if they lead to greater profits being available for investment, distribution or the attainment of other goals of the corporation and are in its best interests.

In addition to the common law duty to act in the best interests of the corporation, there are a number of statutory duties imposed under the *Corporations Act*. From a tax perspective, the statutory duties of care, diligence,<sup>11</sup> good faith and to act in the interests of the corporation<sup>12</sup> are arguably the most important although the latter duty appears to be the primary obligation dealing with tax. It is on this latter duty that next section concentrates.

## 2.2 The duties of care, diligence and good faith

The duty of good faith is owed to the corporation.<sup>13</sup> It is a criminal offence if a director is reckless or intentionally dishonest and fails to exercise his or her powers and duties in good faith in the best interests of the corporation.<sup>14</sup> Risk taking is not a breach of these duties, although risks must be weighed against potential reward for the corporation.<sup>15</sup> It is a breach if directors authorise or permit a company to commit contraventions of provisions of the *Corporations Act*, "or authorise a course which attracts the risk of that exposure (the imposition of penalties), at least if the risk is clear and the countervailing potential benefits insignificant".<sup>16</sup> A full bench of the Supreme Court of New South Wales Court of Appeal was of the view that "the question whether a director has exercised a reasonable degree of care and diligence can only be answered by balancing the foreseeable risk of harm against the potential benefits that could reasonably have been expected to accrue to the company from the conduct in question".<sup>17</sup> It is arguable that permitting a corporation to commit a taxation offence or possibly making it subject to administrative penalties constitutes a breach.

In the leading Australian case on the duty of care, *Daniels*, Justices Clarke and Sheller emphasise that a failure to make proper enquiry is not a defence when a breach of the duty of care and diligence is alleged. They state: "Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct,

<sup>9</sup> *BCE Inc. and Bell Canada v A Group of 1976 Debentureholders* [2008] 3 SCR 560 [37].

<sup>10</sup> *Bell Group Ltd (In Liq) v Westpac Banking Corporation* (No 9) [2008] WASC 239 (28 October 2008) [4389]–[4392].

<sup>11</sup> *Corporations Act* s 180.

<sup>12</sup> *Corporations Act* s 181.

<sup>13</sup> *ASIC v Maxwell* (2006) 24 ACLC 1,308 [102].

<sup>14</sup> *Corporations Act* s 184 (1).

<sup>15</sup> *Vrisakis v Australian Securities Commission* (1993) 11 ACLC 763; *ASIC v Lindberg* [2012] VSC 332 (9 August 2012).

<sup>16</sup> *ASIC v Maxwell* (2006) 24 ACLC 1,308 [104]. See also *ASIC v Sydney Investment House Equities Pty Ltd* [2008] NSWSC 1224 (21 November 2008).

<sup>17</sup> *Vines v ASIC* [2007] NSWCA 75 (4 April 2007), [598].

they did not have a duty to look”.<sup>18</sup> Directors must be familiar with the fundamentals of the business in which the corporation is engaged (including risk management) and must keep themselves informed about the activities of the corporation.<sup>19</sup> This oversight function includes establishing a system to prevent, detect and correct any wrongdoing with reference to tax. This rule is applied in the US. In *Daniels* the majority were of the opinion that directors must ensure they have available “means to audit the management of the company so that it can satisfy itself that the company is being properly run”.<sup>20</sup> A breach of these duties results in liability under the *Corporations Act*.<sup>21</sup>

An objective standard of care is applicable to both executive and non-executive directors.<sup>22</sup> If anything is found to be amiss or the directors are put on enquiry, a proper investigation must be undertaken. Failure to do so is a breach of their duty of care and diligence.

The level of risk, including tax risk, a company is prepared to take in achieving its goals are determined by its board of directors. A company must comply with applicable legal and accounting rules although directors have some discretion in the way they design and operate compliance and governance programs.

In *Disney*, the following examples of conduct were identified as establishing a failure to act in good faith:

Where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.<sup>23</sup>

Although based on a US decision the provisions of the *Corporations Act* and cases cited above suggest the same principles apply in Australia and that even a breach of the anti-avoidance rules may be a failure to act in good faith. It seems that when performing their duties directors do not consciously consider the good faith requirement. Consideration of the company’s best interests would arguably satisfy this test and the analysis in *Disney* above.

This section has shown the statutory duties of care, diligence and good faith require directors to weigh foreseeable risk against potential gain (in part, this is a reiteration of the need to maximise profit). Tax being an unavoidable expense of a company, should be contained. Directors need to devote time and effort to the tax affairs of corporations.

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<sup>18</sup> *Daniels v Anderson* (1995) 13 ACLC 614, 664–5.

<sup>19</sup> In *Re Caremark Int'l*, 698 A.2d 959, 970 (Delaware Chancery, 1996), Chancellor Allen states: I note the elementary fact that relevant and timely *information* is an essential predicate for satisfaction of the board’s supervisory and monitoring role.  
See also *ASIC v Adler* (2002) 20 ACLC 576, 652.

<sup>20</sup> *Daniels v Anderson* (1995) 13 ACLC 614,662. See also *Vines v ASIC* [2007] NSWCA 75 (4 April 2007).

<sup>21</sup> Even where the company makes what turns out to be large profits due to wrongful conduct the directors are liable: *Re Barings plc (No 5)*, *Secretary of State for Trade and Industry v Baker (No 5)* [1999] 1 BCLC 433.

<sup>22</sup> *ASIC v Healey* [2011] FCA 717 (27 June 2011) [172].

<sup>23</sup> *Re Walt Disney Co. Deriv Litig*, 906 A 2d 27, 67 (Delaware, 2006).

In seeking to maximise profits companies must find and exploit manageable risks. Directors must ensure companies pay such taxes as the law requires.

How then should tax be calculated and paid? This is considered next.

### 2.3 The obligation to pay tax

Camp said the following about the US self-assessment system “[u]ndergirding the entire self-assessment regime is the idea that for every taxpayer, there exists a ‘true’ tax liability”.<sup>24</sup> Doran states, “in the view of the IRS, then, ‘tax compliance’ requires that the taxpayer make a correct assessment of their tax liability with all legal uncertainties resolved correctly”.<sup>25</sup> This equates with the Australian position.<sup>26</sup> The foregoing statements have their genesis in what has been said by the highest courts in many countries. For example in the United States, Judge Learned Hand in *Gregory*<sup>27</sup> said:

Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

Lord Wilberforce, in the UK, notes, from the perspective of the regulator, that: “A man is not to be taxed by a dilemma: he must be taxed by positive provision under which the Crown can satisfactorily show that he is fairly and squarely taxed”.<sup>28</sup> In Australia the late Justice Hill said, the Commissioner is “obliged to collect tax in accordance with a correct assessment, that is to say, to collect the correct amount of tax, no more and no less”.<sup>29</sup>

It is only the various taxing statutes that can determine an entity's liability for tax. The basic principle behind a self-assessment system such as that which operates in Australia is that any tax is capable of precise determination in an amount fixed by law. According to Freedman, “companies cannot be expected to pay voluntary tax over and above the amounts imposed by law”.<sup>30</sup>

The Crown is not entitled to retain any tax recovered by virtue of a lack of statutory power.<sup>31</sup> An entity is not obliged to put aside its own interests to pursue a tax policy that is the most beneficial to the government.<sup>32</sup>

<sup>24</sup> Camp Bryan T, Tax Administration as inquisitorial process and the partial paradigm shift in the IRS restructuring and Reform Act of 1998, (2004) 56 *Florida Law Review* No. 1  
<http://mytechlaw.law.ttu.edu/library/faculty/Faculty%20Scholarship%20Files/Camp%2056%20Florida.pdf>.

<sup>25</sup> Michael Doran, ‘Tax Penalties and Tax Compliance’ (2009) 46 *Harvard Journal on Legislation* 111, 140.

<sup>26</sup> *Taxation Administration Act 1953* (Cth) s 166A.

<sup>27</sup> *Gregory v Helvering, Commissioner of Internal Revenue* 69 F.2d 809 (1934).

<sup>28</sup> *IRC v Holmden* [1968] AC 685, 712.

<sup>29</sup> *Brown v Commissioner of Taxation* 99 ATC 4516, 4526 [51].

<sup>30</sup> Judith Freedman, ‘Tax and Corporate Responsibility: In My Opinion’ (2003) 695 *Tax Journal* 2, 6.

<sup>31</sup> *Woolwich Equitable Building Society v Inland Revenue Commissioners* [1992] 3 All ER 820.

<sup>32</sup> Richard Happe, ‘Multinationals, Enforcement Covenants, and Fair Share’ in J Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management* (Oxford University Centre for Business Taxation, 2008) 157.

The inevitable consequence of the foregoing is that corporations are entitled to arrange their affairs to pay only such tax as the law requires. The Commissioner acknowledges “[t]ax planning is a key feature of any tax landscape”.<sup>33</sup>

Notwithstanding the foregoing it would appear that the ATO believes that corporate entities should pay what is described as their ‘fair share of tax’ or take the interests of the community into account when determining their tax liability and act as a ‘good corporate citizen’. For example the Commissioner said:

Compliance is a rather strong sounding word. Perhaps it is better to think in terms of fairness, for that is what compliance with our tax laws is all about. It is about people paying their fair share as set by our laws.<sup>34</sup>

The Commissioner reverts to this theme on numerous occasions.<sup>35</sup>

The acceptance by the Commissioner that tax planning is legitimate is somewhat contrary to calls for companies to pay a ‘fair share of tax’ or to act as a ‘good corporate citizen’. The tension between these two positions is discussed in the next section which is divided into two parts. The first considers the concepts of a ‘fair share of tax’ and ‘good corporate citizenship’ whilst the latter reviews CSR.

### 3. PAY A ‘FAIR SHARE OF TAX’ AND ACT AS A ‘GOOD CORPORATE CITIZEN’

Freedman, Loomer and Vella undertook a survey investigating the attitudes and opinions of some large businesses and Her Majesty’s Revenue and Customs (HMRC) and report that:

All of these respondents agreed that it was acceptable for a taxpayer to implement a business-led transaction in the most tax effective manner ... corporation tax is a significant cost against business profits; reducing that cost in order to maintain competitive position or enhance shareholder value was seen as a valid commercial objective in itself.<sup>36</sup>

A survey conducted by Rawlings indicates that there is a perception that high wealth and corporate taxpayers do not pay their proportionate share of tax.<sup>37</sup>

<sup>33</sup> Michael Carmody Commissioner of Taxation *Managing Compliance* Address to The Tasmanian Chamber of Commerce and Industry 3 September 2003

<sup>34</sup> Michael Carmody, ‘The State of Play Five Years On’ (Address to Taxation Institute of Australia Victorian Division 3 February 1998).

<sup>35</sup> See for Commissioner of Taxation, ‘*Consultation, collaboration and co-design: The way forward for the tax office*’ (Address to Australian Public Service Commission SES Breakfast, Boathouse by the Lake, Canberra 21 September 2006).

<sup>36</sup> Judith Freedman, Geoffrey Loomer and John Vella, ‘Moving Beyond Avoidance? Tax Risk and the Relationship between Large Business and HMRC’ in Judith Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management* (Oxford University for Business Taxation, 2008) 81, 90.

<sup>37</sup> Gregory Rawlings, ‘Cultural Narratives of Taxation and Citizenship: Fairness, Groups and Globalisation’ (Working Research No 52, Centre for Tax System Integrity, Australian National University, February 2004) 1.

Similar results were obtained in a survey conducted by Valerie and John Braithwaite.<sup>38</sup>

Since tax is essentially a private affair, particularly having regard to the secrecy provisions of the *Taxation Administration Act 1953* (Cth) (*TAA*), the results of the surveys conducted by Rawlings and John and Valerie Braithwaite may reflect an incorrect view on the part of the respondents interviewed on how tax is imposed, calculated and paid by corporations. No one knows what is declared and in what amount tax is paid, with the exception of some corporations that must publish their results. Even where returns are published there is no means of determining whether the company has or has not complied with its obligations under the tax laws. Recent legislation (*Tax Laws Amendment (2013 Measures No 2) Act 2013* (Cth)) overrides the secrecy provisions contained in the *TAA* by requiring the Commissioner to publish information about corporations with a turnover in excess of \$100 million. The reasons advanced for the introduction and effect of these provisions is outside the scope of this article.

According to Kahan, regulators adopt the approach that taxpayers who have faith in the willingness of others to pay the tax imposed on them will reciprocate by doing the same. Thus, the Commissioner's calls for entities to pay a 'fair share of tax' may be aimed at persuading those who do not pay the taxes imposed on them to do so, presumably to reinforce the willingness of others to comply. Kahan refers to this as the 'logic of reciprocity'.<sup>39</sup>

If the Commissioner is of the view that taxpayers are obliged to pay tax in accordance with the law—something that is not open to any form of challenge—then requests to pay a 'fair share of tax' seems inappropriate. This adds an element of uncertainty and subjectivity and possibly even a political element to what should be an entirely objective concept. The Commissioner is entrusted with the administration of the tax laws, not nebulous concepts such as 'fairness' or 'good citizenship'.

The Commissioner has never (and can never) explain what is meant by a 'fair share' of tax. According to Slemrod "[t]here is an active controversy about what exactly fairness means".<sup>40</sup>

Does the payment of a 'fair share of tax' mean that corporate taxpayers must pay the headline rate, or is this an allusion to some other percentage? If the latter, how is this percentage to be determined and by whom? What if the various taxing acts provide that certain income is not assessable? For example, certain income derived from overseas businesses controlled by Australian companies is not assessable income and is not exempt income of the company.<sup>41</sup> To suggest that, because some corporate

<sup>38</sup> Valerie Braithwaite and John Braithwaite, 'Democratic Sentiment and Cyclical Markets in Vice' (November 2006) 46 *British Journal of Criminology* 1110, 1111–4. See also: Valerie Braithwaite, 'Perceptions of Who's Not Paying Their Fair Share' (Working Paper No 54, Centre for Tax System Integrity, Research School of Social Sciences, Australian National University, February 2004).

All authors are referred to by their surnames in the body of this article other than for John and Valerie Braithwaite. The reason is to avoid confusion between these two scholars.

<sup>39</sup> Dan M Kahan, 'Logic of Reciprocity: Trust, Collective Action, and Law' (2003–2004) 102 *Michigan Law Review* 71.

<sup>40</sup> Joel Slemrod, 'Old George Orwell Got it Backward: Some Thoughts on Behavioral Tax Economics' (CESIFO Working Paper No 2777, Category 1: Public Finance, September 2009) 5. See also: Donna J Wood and Jeanne M Logsdon, 'Business Citizenship as Metaphor and Reality' (January 2008) 18(1) *Business Ethics Quarterly* 51.

<sup>41</sup> *Income Tax Assessment Act 1936* (Cth) ss 23AI–23AJ.



taxpayers have an effective tax rate of 20 or 10 per cent as opposed to the headline rate of 30 per cent, they are not paying their fair share is meaningless unless one knows how the tax is calculated and whether this is in accordance with the law. If in accordance with the law the reference to 'fairness' is redundant. One need only pose the question of what is a 'fair share of tax' to understand the futility of attempting an answer.

Another problem with the concept of a 'fair share of tax' is the multitude of techniques that governments adopt to increase the tax burden without directly stating they are doing so. Taxpayers tend to underestimate the total tax they pay when the amount is spread over various taxes or when different techniques are used to cause voters to underestimate the true cost of government.<sup>42</sup> For example, by switching from manual, per-trip remittance of traffic tolls to automatic electronic charging, Finkelstein argues that toll increases are facilitated because the act of remittance becomes less salient to drivers/voters.<sup>43</sup>

Gribnau argues that ethics and morality have a role to play in determining how far a corporation should go in determining its risk policy and the extent to which it will take advantage of tax planning opportunities. According to Gribnau, the ethical factors to be considered when interpreting tax legislation may exceed the legal ones. However, he concedes that not all tax planning is unethical. He argues that what is not utilised by corporations is a value judgment as to what constitutes aggressive tax planning and avoidance.<sup>44</sup>

Tulberg cites various philosophers who are critical of altruism and oppose claims of never-ending duties when dealing with tax issues.<sup>45</sup> Williams refers to the morality system as a punitive structure of obligations, blame and guilt.<sup>46</sup> Morse suggests that responsive regulation is not a good basis for 'prosocial strategies' (persuading taxpayers that compliance is the socially acceptable or moral choice) because the foundation necessary for building a trusting relationship (a prerequisite for responsive regulation) is likely to be absent between the ATO and non-compliant taxpayers. Morse queries why tax regulators follow such a strategy, having regard to the limited empirical evidence that such strategies work.<sup>47</sup>

The author suggests that directors should always act in the interests of the company and if tax mitigation is in such interests directors have an obligation to act. Morality, although an important concept, plays no part in determining a corporation's liability

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<sup>42</sup> Slemrod, above n 38, 14.

<sup>43</sup> Amy Finkelstein, 'EZ Tax: Tax Salience and Tax Rates' (NBER Working Paper No 12924, February 2007).

<sup>44</sup> Hans Gribnau, 'CSR and Tax Planning Not by Rule Alone' (Paper delivered at the TRN Conference, Exeter, UK, September 2013). It is notable that the 'fair share of tax', 'morality' and 'ethics' approaches do not consider the case in which taxes have been unfairly overpaid.

<sup>45</sup> Jan Tulberg, 'Reflections upon the Responsive Approach to Corporate Social Responsibility' (2005) 14(3) *Business Ethics: A European Review* 261, 268–270. The following are cited in support: Bernard Williams, *Ethics and the Limits of Philosophy* (Fontana Press, 1985); David P Gautier, *Moral Dealing: Contracts, Ethics and Reason* (Cornell University Press, 1996); J Mackie, *Ethics: Inventing Right and Wrong* (Harmondsworth Penguin, 1977).

<sup>46</sup> Bernard Williams, *Ethics and the Limits of Philosophy* (Routledge, first published 1985, 2011 ed), ix.

<sup>47</sup> Susan C Morse, 'Narrative and Tax Compliance' (University of California Hastings Research Paper No 14, 24 September 2013).

for tax although it should ensure that a company does not seek to reduce its tax liability to an amount less than that required by law.

That a taxpayer acts within the law but immorally is not a basis for a court to intervene.<sup>48</sup>

This article argues there is no basis for the proposition that a company is obliged to pay tax in an amount other than as prescribed by law. There is no basis for assessing or calculating tax by reference to what constitutes a 'fair share'. This is so whether one states that the concept means to act as a good corporate citizen; or if the meaning is to preclude corporations adopting tax policies that have as their goal the limitation of a company's tax liability to that prescribed by law. Either the law provides for an obligation to pay a tax or it does not.

Hartnett, the former Permanent Secretary for Tax and the Commissioner of HMRC, implicitly acknowledges that paying a 'fair share' of tax means paying more tax than the law requires. Hartnett states:

In broad terms, corporates recognise tax as a cost to business and that paying more tax than is strictly due may breach legal duties and obligations to shareholders. But an increasing number of corporates see real worth in a positive working relationship with tax administrations and they value a good reputation with governments, their customers, employees and the public at large.<sup>49</sup>

Hartnett is also reported as asking "with increasing numbers of investors taking an interest in the ethical and social policies of companies ... are we now at a time when corporate responsibility demands a new attitude to tax avoidance?"<sup>50</sup> Hartnett is suggesting that tax administrations have been given license by the general community (where there may be a heightened sense of ethics and morality) to enforce the UK tax laws. Provided the law is applied in accordance with its terms rather than some nebulous 'fair share' or 'good citizenship' standard, there should be no problem.

The ATO also tries to influence the way tax is calculated by corporations by suggesting that the manner in which this is done may reflect good corporate citizenship by taking the community into account when determining a company's tax liability. The public benefit in any one taxpayer paying more tax than the law provides is minimal. In Morse's view, to most taxpayers the reference to public benefit is remote, confusing and boring.<sup>51</sup> Corporations cannot give to the community via the tax system; they can only give to the state. The two are not identical.<sup>52</sup> There is a difference between complying with an obligation imposed by law and paying some amount incapable of precise determination. The concept of 'good corporate citizenship' is subject to the same criticisms as is the concept a 'fair share of tax'.

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<sup>48</sup> *Re Fortex Pty. Limited* 86 ATC 4351, 4358 (Enderby J).

<sup>49</sup> David Hartnett, 'Tax and Corporate Governance' (Speech delivered at the International Network for Tax Research, 8–9 December 2006).

<sup>50</sup> Henderson Global Investors, 'Tax Risk and Corporate Governance' (Report on a survey made of 350 companies quoted on the London Stock Exchange, October 2005).

<sup>51</sup> Susan C Morse, 'Tax Compliance and Norm Formation under High-Penalty Regimes' (2012) 44(3) *Connecticut Law Review* 675.

<sup>52</sup> David F Williams, 'The Concept of Tax Governance' (Paper presented at the KPMG Tax Business School, UK, 2007).

In making the claim for companies to act as ‘good corporate citizens’ the Commissioner seeks to raise some moral obligation or some form of contract in calculating and paying their taxes. The Commissioner contends large business and the ATO have mutual obligations to ensure that the compliance process is working efficiently and effectively, and to demonstrate to the wider community how it works. According to the Commissioner, the challenge for the ATO and the business sector is to facilitate and support good corporate citizenship that will strengthen the Australian economy and promote the well-being of Australian society.<sup>53</sup> The call here is not for the payment of taxes as mandated by the law but rather for taxpayers to consider the community in determining how to conduct their tax affairs. The Commissioner never explains the basis or foundation for this sweeping statement. The obligation of taxpayers is limited to compliance with the tax laws and paying all such taxes as required by law.

If taxpayers accede to interpretations of the law made by the Commissioner that may be incorrect, or if they do not claim deductions or other benefits to which they are entitled as a result of statements made by the Commissioner, this may give the Commissioner a de facto power to impose tax, or at least may subvert the role of the courts to resolve disputes and declare the meaning of disputed legislation. Dabner and Burton say:

In practice, a taxpayer’s risk assessment will typically result in the administrator’s interpretation being a proxy for what is ‘correct’. To then say that the parties have a common interest to see that the ‘correct’ amount of tax is paid ignores the reality that the parties have a different view of what is ‘correct’, and thus no shared vision.<sup>54</sup>

If the Commissioner has inadvertently or intentionally assumed the power to impose tax or negates the role of the courts, it is beyond the authority granted to the Commissioner by the tax laws.<sup>55</sup> It would place too much power in the hands of the regulator if taxpayers were bound by its apparent unfettered discretion to determine the meaning and operation of the law.

Pascal Saint-Amans (Director of the Centre for Tax Policy and Administration, OECD) is reported to have said:

Policy makers cannot blame businesses for using the rules that governments themselves have put in place. It is their responsibility to revise the rules or introduce new rules to address existing concerns.<sup>56</sup>

<sup>53</sup> See for example: Chris Jordan, ‘Tax, The Way Ahead’ (Speech delivered at Tax Institute 28th Annual Convention, Perth, 14 March 2013).

<sup>54</sup> Justin Dabner and Mark Burton, ‘The “Enhanced Relationship” Model Collides with Reality — The Determinants of the Relationship between Tax Administrators and Tax Intermediaries’ (Paper delivered at the Law and Society Association Annual Conference, 5–8 June 2012, Hawaii).

<sup>55</sup> See, for example, *Matthews v The Chicory Marketing Board (Vic)* (1938) 60 CLR 263; *Air Caledonie International v Commonwealth of Australia* (1988) 82 ALR 385; *MacCormick v Federal Commissioner of Taxation* (1984) 158 CLR 622; *R v Barger* (1908) 6 CLR 41; *DCT v Brown* (1958) 100 CLR 32.

<sup>56</sup> Greg Wibe, ‘Interview with Pascal Saint-Amans’ cited in KPMG, *Cutting through Complexity — What Should Governments Tax — A Question of Morality or Policy?* <<http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/future-focus-tax-asia-pacific/Pages/oecd-report.aspx>>.

For Saint-Amans, the solution to low effective corporate tax rates is to be found in tax policy and not in rhetorical demands.

The confusion between tax that is imposed by statute and some imprecise moral imperative has important consequences for the manner in which the media and others treat companies in relation to their tax affair.<sup>57</sup> For example, in evidence before the UK Parliament's Public Accounts Committee, the chair, Margaret Hodge, in a question to Matt Brittin, vice-president for Google Incorporated (Google) in northern and central Europe, said "[w]e are not accusing you of being illegal; we are accusing you of being immoral".<sup>58</sup> What Hodge appears to be saying is that the UK would like Google to pay more tax than that required by UK law. If this inference is correct then politicians such as Hodge are assuming an unlegislated entitlement on the part of the UK tax authorities.

There is evidence that some large companies are acceding to the power of pressure groups in relation to tax.<sup>59</sup> KPMG note:

The emergence of pressure groups ... is further evidence of the higher profile of tax on the wider business stage. Tax management has been the target of some emotional and, arguably, inaccurate comment in an increasingly heated debate about whether corporations are paying their 'fair share' of taxes ... 'naming and shaming' attacks on alleged tax avoiders can damage their reputations in the eyes of important stakeholders, which can lead to sharp short-term share price falls and the unwelcome attention of more than one taxing authority.<sup>60</sup>

Kagan, Gunningham and Thornton note a growing body of literature focusing on the role of social pressures in shaping company behaviour.<sup>61</sup> These pressures derive from shareholders, advocacy groups, individuals and community groups that lodge complaints with regulatory agencies and courts. In doing so, these groups create adverse publicity that damages a company's reputation. These pressure groups wield immense power. Baxt notes how shareholder activism can be used to force companies to consider community issues.<sup>62</sup> These pressure groups often require companies to make contributions to the community and to do more than operate their businesses successfully to maximise profits.

Irrespective of the demands of these pressure groups, it is the duty of a director to act in the best interests of the corporation and to maximise shareholder wealth. If directors intentionally cause a company to pay more tax than the law provides without any corresponding advantage to the company, they breach their duty to act in the best interests of the corporation as well as their duty of good faith.

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<sup>57</sup> Naming and shaming is beyond the scope of this article.

<sup>58</sup> UK Parliament, Evidence to Parliament's Public Accounts Committee (2 November 2012) (Margaret Hodge).

<sup>59</sup> KPMG LLP, *The Tax Function, Facing up to the Changing World* (KPMG LLP, 2006).

<sup>60</sup> KPMG LLP, *Tax in the Boardroom: A Discussion Document* (2004).

<sup>61</sup> Robert A Kagan, Neil Gunningham and Dorothy Thornton, 'Explaining Corporate Environmental Performance: How Does Regulation Matter?' (March 2003) 37(1) *Law & Society Review* 51, 68.

<sup>62</sup> Robert Baxt, 'Future Directions for Corporate Law: Where are We Now and Where do We Go from Here? The Dilemmas of the Modern Company Director' (2011) 25 *Australian Journal of Corporate Law* 213.

As Friedman stated:

There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.<sup>63</sup>

Heard believes paying a ‘fair share of tax’ and CSR distorts allocative efficiency.<sup>64</sup>

The foregoing authors concur that it is the function of a company to maximise shareholder wealth. Although disagreeing with Friedman’s reasoning, Bainbridge is of the view that the function of a director is to maximise shareholder wealth,<sup>65</sup> which is usually achieved by increasing after-tax profits. In compliance with their obligations to act in the best interests of the corporation, directors must ensure they maximise the advantages and minimise the risks of the corporation.

It is apposite to conclude this section by referring to what Sir Anthony Mason says on this topic: ‘as a taxpayer can’t be expected to pay tax when it is not legally payable, legislative amendment rather than rhetoric is the answer to the problem’.<sup>66</sup>

The next part considers a related call by tax administrators and the public for companies to accept and follow principles of CSR when dealing with tax issues.

### 3.1 Corporate social responsibility

Avi-Yonah, discussing CSR, refers to three theories about tax and the corporation and states that corporations should not enter into tax minimisation schemes under any theory because:

Under the artificial entity view, it undermines the constitutive relationship between the corporation and the state. Under the real view, it runs contrary to the normal obligation of citizens to comply with the law even in the absence of effective enforcement. And under the aggregate view, it is different from other forms of shareholder profit maximisation in that it weakens the ability of the state to carry out those functions that the corporation is barred from pursuing.<sup>67</sup>

There are a number of difficulties with Avi-Yonah’s view. Firstly, even if the company is a creation of the legislature (state), this does not mean its tax obligations should be greater than the law provides. If this were the case, an immediate problem would be to determine how much tax should be paid. Secondly, the fact that the

<sup>63</sup> Milton Friedman, ‘The social responsibility of business is to increase its profits’ *The New York Times Magazine* (New York) 13 September 1970. Slemrod suggests this view may be impacted by reputational concerns on the part of the corporation: Joel Slemrod, ‘The Economics of Corporate Tax Selfishness’ (NBER Working Paper No 10858, October 2004).

<sup>64</sup> Victoria Heard, ‘The Philosophy of Tax’ (Research paper delivered at the KPMG Business School, UK, 2005).

<sup>65</sup> Stephen M Bainbridge, ‘In Defence of the Shareholder Wealth Maximization Norm: A Reply to Professor Green’ (1993) 50 *Washington and Lee Law Review* 1423.

<sup>66</sup> Sir Anthony Mason, ‘Opening Address’ in K H Datt, B Tran-Nam and K Bain (eds), *International Tax Administration: Building Bridges* (CCH Sydney, 2010) 3, 5.

<sup>67</sup> Reuven S Avi-Yonah, ‘Corporate Social Responsibility and Strategic Tax Behavior’ in Wolfgang Schon (ed), *Tax and Corporate Governance* (Springer, Berlin Heidelberg, 2008) 183.

corporation cannot perform certain functions that are the exclusive preserve of the state is not a basis for requiring corporate taxpayers to pay an indeterminate amount to the revenue. If this latter argument had any validity, all taxpayers would be required to pay more tax than provided by law in some amount that is incapable of determination. Thirdly, compliance with the law does not mean that a corporation must voluntarily pay more tax than required by law.

Pekka comments on the views of Avi-Yonah as follows:

We must firstly keep in mind that paying taxes has not been recognized as a primary CSR obligation and I am not sure if it is even a secondary one. Secondly it should be noted that tax planning or strategic tax behavior are normally considered problematic by the state only (the one losing cash flows from taxes) and other stakeholders seldom react to it. Thirdly this means that it is extremely difficult to claim that a company is promoting the enlightened value maximization by voluntarily paying taxes as it is quite difficult to see the connection between short-term cost and expected long-term profit. Instead, taxes are treated as standard costs which companies should minimize whenever that is possible by legal means.<sup>68</sup>

Other than possibly preserving a company's reputation, or achieving a trouble-free relationship with the ATO there appears to be no apparent advantage in paying more tax than required by law. Naming and shaming should not occur if corporations have paid all tax required by the law. Not minimising tax, on the other hand, may be a breach of the duty of directors to act in the best interests of the company.

There is no limit to the power of Parliament to enact taxation laws, provided they meet the constraints prescribed by the *Constitution*.<sup>69</sup> If the state requires additional revenue to meet its social or other agendas, it has the power to legislate for additional tax. The state's need for revenue should not require a company to pay tax in an amount other than as the law requires. If companies wish to do good deeds, they can do so openly and gain the benefits of being good citizens.

When discussing the boundaries and obligations of companies in relation to CSR, Lantos states:

For any organization ethical CSR (avoiding societal harms) is obligatory, for a publicly-held business altruistic CSR (doing good works at possible expense to stockholders) is not legitimate, and ... companies should limit their philanthropy to strategic CSR (good works that are also good for the business).<sup>70</sup>

According to Lantos, corporations should not act purely out of benevolence for three reasons. Firstly, using corporate resources for social works may breach the obligation to maximise profits. Secondly, the corporation's shareholders may not be financially well off and may rely on the payment of dividends or capital appreciation to fund their

<sup>68</sup> Timonen Pekka, 'Corporate Social Responsibility and Strategic Tax Behavior — Comment on the Paper by Reuven S Avi-Yonah' in Wolfgang Schon (ed), *Tax and Corporate Governance* (Springer, Berlin Heidelberg, 2008) 199.

<sup>69</sup> *R v Barger* (1908) 6 CLR 41 (Isacss J).

<sup>70</sup> Geoffrey P Lantos, 'The Boundaries of Strategic Corporate Social Responsibility' (2001) 18(7) *Journal of Consumer Marketing* 595, 595.

daily expenditures. Thirdly, altruistic CSR forces stockholders to sacrifice part of their income so that managers can be generous with shareholders' funds. Lantos accepts that being socially responsible does not mean that profits will decline. They might rise because of favourable publicity. Moreover, enhanced employee morale might lead to greater productivity and less government intervention. However, if a business prospers, this is because of strategic, not altruistic, CSR.<sup>71</sup> Strategic CSR is appropriate even if the gain is not immediately visible in a company's financial statements.<sup>72</sup> There is nothing wrong with doing well simultaneous to doing good deeds.<sup>73</sup> In these circumstances, directors are acting in the best interests of the corporation. By contrast, it seems that making a gift to the revenue by paying more tax than prescribed by law is not such a good deed.

Having reviewed the concepts of a 'fair share of tax', 'good corporate citizenship' and CSR this article turns to a consideration of aggressive tax planning, and its relationship, if any, to avoidance.

#### 4. AGGRESSIVE TAX PLANNING AND AVOIDANCE

Tax avoidance in Australia occurs when a transaction breaches the (specific and general) anti-avoidance rules. These rules prescribe criteria that must be met before the tax consequences of a transaction can be set aside as invalid as against the Commissioner.<sup>74</sup> In some jurisdictions, the courts may resort to statutory interpretation or other tools to protect the revenue from tax avoidance schemes. In the UK, the Commissioner can rely either on the General Anti Avoidance Rule (GAAR), enacted in 2013,<sup>75</sup> or the *Ramsay* principle as a means of challenging what HMRC contend to be an avoidance scheme.<sup>76</sup> The *Ramsay* principle requires a court to interpret legislation purposively and then to apply that finding to the facts found as a composite whole and viewed realistically.

The Commissioner and regulators in other jurisdictions refer to avoidance as following the letter, but not the spirit, of the law; or not following the policy of the law; or as being a scheme that undermines the integrity of the tax system. According to Hasseldine and Morris, references to the 'spirit of the law' imply "the existence of some form of shadowy parallel tax code to which only a privileged few have access while everyone else has to make do with the 'letter' of the law".<sup>77</sup> Freedman argues

<sup>71</sup> Ibid 610–611.

<sup>72</sup> 'Strategic giving' is also referred to by Schwartz and Carroll: Mark S Schwartz and Archie B Carroll, 'Corporate Social Responsibility: A Three-domain Approach' (2003) *Business Ethics* 503, 507.

<sup>73</sup> Tulberg, above n 44. For a view critical of CSR, see, Bruce Welling, 'Corporate Social Responsibility — A Well-meaning but Unworkable Concept' (2009) *Corporate Governance eJournal* <publications.bond.edu.au>.

<sup>74</sup> The transaction is legal and binding on the parties in all other respects.

<sup>75</sup> This legislation does not refer to a GAAR but to an 'anti-abuse rule' contained in Part 5 of the *Finance Act* 2013.

<sup>76</sup> *W T Ramsay Ltd v CIR* [1981] 1 All ER 865.

<sup>77</sup> John Hasseldine and Gregory Morris, 'Corporate Social Responsibility and Tax Avoidance: A Comment and Reflection' (2013) 37(1) *Accounting Forum* 1, 11.

that proper consideration has to be given to the actual legal position, rather than focusing on vague and unenforceable notions such as the ‘spirit of the law’.<sup>78</sup>

References to concepts such as the ‘spirit’ or ‘policy’ of the law do not add much to the enquiry about the distinction between tax planning and tax avoidance, although the ‘spirit’ or ‘policy’ of the law are relevant to a court when seeking to interpret a statutory provision. For example, when interpreting the GAAR, a court may have regard to the policy behind the law or the ‘spirit of the law’. However, once the meaning and purpose of the legislation have been determined, these concepts play no further role in assessing whether a transaction is affected by the GAAR.

Regulators, including the ATO and OECD, also refer to a concept they call ‘aggressive tax planning’.<sup>79</sup> It seems common cause that tax planning is permissible; however, all regulators take issue with aggressive tax planning. This article takes the view that either a tax minimisation scheme is effective for tax purposes or it is not. If the regulator is unable to successfully challenge a transaction that reduces tax, how the arrangement or scheme is described is irrelevant; it is legally unobjectionable and amounts to legitimate tax planning. In such a case, a change in the law is the only way to ensure these transactions are subject to tax. The House of Lords notes that it is primarily for the UK government to correct flaws in the (corporations) tax regime. If there is manipulation, the best way to counter this is to tighten the regulatory framework.<sup>80</sup> “There is no substitute for improving the tax code to reduce tax avoidance”.<sup>81</sup>

The Commissioner, in what appears to be an attempt to increase the tax take, has made suggestions that those taxpayers that embark on ‘aggressive tax planning’ are non-compliant and that such schemes should not be concluded. For example in 2013, the Commissioner stated “we are seeing some of the 1,300 large and international businesses adopt aggressive tax structures to avoid their obligations”.<sup>82</sup> It is not clear what the Commissioner means by the use of the word ‘avoid’ in the previous extract. If a scheme is hit by the anti-avoidance rules, it is avoidance and the Commissioner has the remedies granted by the tax laws. It seems the Commissioner may be referring to those schemes not hit by the anti-avoidance rules but which limit the tax of corporations in circumstances in which the ATO believes more tax should be paid. It seems the Commissioner overreaches his administrative power by applying vague characterisations of taxpayer behaviour as if they have a legislative foundation.

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<sup>78</sup> Judith Freedman, ‘Responsive Regulation, Risk and Rules: Applying the Theory to Tax Practice’ (2012) 44(3) *University of British Columbia Law Review* 627, 648–51.

<sup>79</sup> Freedman, Loomer and Vella suggest that aggressive tax planning and avoidance are synonymous: Judith Freedman, Geoffrey Loomer and John Vella, ‘Corporate Tax Risk and Tax Avoidance: New Approaches’ (2009) 9(1) *British Tax Review* 74, 75.

<sup>80</sup> House of Lords, Select Committee on Economic Affairs; 1st report of session 2013–14: *Tackling corporate tax avoidance in a global economy: is a new approach needed?* (2013) [136], [145].

<sup>81</sup> *Ibid* [148].

<sup>82</sup> ATO, *Compliance in Focus: 2013* (Last modified 7 July 2013).



The ATO incorrectly operates on the implicit assumption that the law is constant and known to all.<sup>83</sup> The complexity of the tax laws makes it difficult for the regulator to justify such an approach. As Picciotto states:

Various players may have different and genuinely-held understandings of a rule's meaning, and may each consider theirs the correct and clear meaning. As such, people who regard themselves as compliant based on their understanding of the regulatory requirements may, from the regulator's viewpoint, be avoiders or game-players.<sup>84</sup>

Valerie Braithwaite, Reinhart and McCrae view game playing as an attempt to cheat the system to limit the amount of tax paid.<sup>85</sup> Arranging a corporation's affairs to reduce its tax liability to no more than is prescribed by law is not cheating. Some taxpayers may attempt to cheat the system, but in such circumstances, there are myriad provisions (civil and criminal) in both the *Corporations Act* and tax laws to address such conduct. The majority of companies seek to comply, but may be faced with the dilemma postulated by Picciotto above.

The ATO appears to try to persuade taxpayers not to venture into areas of uncertainty, or to develop structures that take advantage of these uncertainties, even where there is a reasonable prospect that a court would find the taxpayer's view of the law to be correct. Friese, Link and Mayer argue that regulators:

Make use of a large range of deterring measures such as threatening intensive auditing, procedural pressure, negative publicity, *etc.* Thereby they create a quasi-illegal status that is not in line with the classical distinction. In such an environment ambiguous tax statutes become a method for raising revenues as taxpayers are forced to stick to unchallenged positions.<sup>86</sup>

Duff has a similar view.<sup>87</sup>

An exacerbating factor is that the Commissioner operates on the basis that the ATO's view of the law is the correct one. An example of this can be seen from the following statement by the Commissioner:

<sup>83</sup> For an article discussing the issues that may arise due to what is referred to as 'indeterminate law', see, Mark Burton, 'Responsive Regulation and the Uncertainty of Tax Law — Time to Reconsider the Commissioner's Model of Cooperative Compliance?' (2007) 5(1) *eJournal of Tax Research* 71 <[http://www.asb.unsw.edu.au/research/publications/ejournaloftaxresearch/Documents/paper4\\_v5n1.pdf](http://www.asb.unsw.edu.au/research/publications/ejournaloftaxresearch/Documents/paper4_v5n1.pdf)>.

<sup>84</sup> Sol Picciotto, 'Constructing Compliance: Game Playing, Tax Law, and the Regulatory State' (January 2007) 29(11) *Law & Policy* 11, 12.

<sup>85</sup> Valerie Braithwaite, Monika Reinhart and Jason McCrae, 'Game Playing with Tax Law' (Research Note No 8, Centre for Tax System Integrity, 2004). The view of these authors is reminiscent of the Speech of Lord Morris in *Lupton v F.A. & A.B. Ltd* 47 TC 618, in which it was said that '[o]thers think of the analogy of a wolf in sheep's clothing with the revenue as the prey', cited by David Goldberg, 'The Approach of the Courts to Tax Planning Schemes', <[http://www.taxbar.com/documents/Approach\\_Courts\\_David\\_Goldberg.pdf](http://www.taxbar.com/documents/Approach_Courts_David_Goldberg.pdf)>.

<sup>86</sup> Arne Friese, Simon Link and Stefan Mayer 'Taxation and Corporate Governance—The State of the Art' in Wolfgang Schon (ed), *Tax and Corporate Governance* (Springer Berlin Heidelberg, 2008) 400.

<sup>87</sup> David Duff, 'Relationships, Boundaries, and Corporate Taxation: Compliance and Avoidance in an Era of Globalization' in Judith Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management* (Oxford University for Business Taxation, 2008) 197, 200–201.

Case planning starts with a high-level risk hypothesis that either:

1. some taxpayers may not be applying the law in accordance with our view and, therefore, are not paying the correct amount of tax
2. the application of the law may be having unintended consequences.<sup>88</sup>

The Commissioner says “I want business to clearly know, if they choose questionable or very aggressive practices there will be consequences”.<sup>89</sup> However, the only practical consequence that can flow is the use of the anti-avoidance rules if appropriate. If the ‘consequences’ for corporations utilising such schemes, where these are compliant with the law, is pressure imposed by the ATO to make this behaviour more expensive, this would also appear to be outside the powers granted to the Commissioner. The Commissioner is not entitled to impose a tax that would otherwise not be payable.

The Commissioner appears to refer to “game playing”, where the ATO is beaten (presumably legitimately) through smart moves and reliance on grey areas of the law.<sup>90</sup> ‘Game playing’ and ‘aggressive tax planning’ seem to be synonymous terms. However, it is not ‘game playing’ or ‘aggressive tax planning’ when tax minimisation schemes cannot be successfully challenged. This appears to be another attempt to utilise subjective and emotive terms that mean whatever the Commissioner wishes them to mean. Hartnett says:

The big issue for tax administrations is that aggressive and artificial tax shelters and schemes across the globe, promoted by advisers once more renowned for caution and the accuracy of their work than for breathtaking creativity in relation to tax, have at times reduced to nothing the tax paid by individuals and corporates who are often the persons best placed to pay the taxes governments expect of them.<sup>91</sup>

Implicit in the above statement is an inability on the part of HMRC to challenge some or all of these schemes. If no challenge can be made, no matter how breathtakingly creative they may be, the complaint by Hartnett is misplaced. If there is a problem it is that the law is unable to tax certain transactions or income or disallow certain deductions. The remedy is to change the law.

Further the statement by Hartnett suggests that: ability equates to an obligation to pay; and wealthy individuals and corporations should not take advantage of enacted provisions that enable them to reduce their tax liability. If these are correct, this would appear as an indictment of HMRC and other regulators that have a similar approach to revenue collection. It may even constitute a call for directors to breach their obligations under the *Corporations Act*. Directors have an obligation to act in the best interests of the company. It is reasonable for directors, in carrying out their *Corporations Act* obligations, to structure transactions to legitimately minimise a tax liability if it is in the interests of the corporation to do so. That a corporation has the

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<sup>88</sup> ATO, Large Business Active Compliance Manual—Income Tax (Last modified 9 July 2013).

<sup>89</sup> Jordan, above n 51.

<sup>90</sup> Michael Carmody, ‘Taxation, Current Issues and Future Directions’ (Speech delivered at the Australian Institute of Company Directors, Perth, 1 May 2001).

<sup>91</sup> David Hartnett (Speech delivered at the International Network for Tax Research, 8–9 December 2006).

means to pay more tax than the law requires is irrelevant in the determination of that company's tax liability.

That taxpayers may have a different view of the law to the regulator does not mean they have no sense of morality or business ethics or are non-compliant.<sup>92</sup> Corporations are not obliged to pay more tax than is mandated by law. Taxpayers who seek to comply with the law should not be regarded as enemies, but rather should be seen as colleagues with whom the regulator disagrees. This would change the dynamics of the discussion and debate between the parties. The Commissioner's public statements suggest a different approach.

Aggressive tax planning is said by the ATO to refer to schemes and arrangements that undermine the integrity of the tax system and erode community confidence in the fairness and equity of that system.<sup>93</sup> Statements such as this and other references to 'aggressive tax planning' are unhelpful, as they do not explain to taxpayers how to recognise an aggressive tax planning scheme and do not identify the criteria used by the Commissioner to determine which schemes might be challenged successfully. If corporations pay all the tax required by law, the integrity of the system cannot be impaired in any way. The contrary is the case. To suggest that paying all the tax the law requires can undermine community confidence in the fairness and equity of the system suggests some inherent problem with the system itself and would appear to be based on a misconception of a taxpayer's obligations.

The OECD believes that large corporate taxpayers and high net wealth individuals are the most likely to adopt aggressive tax planning strategies.<sup>94</sup> The OECD describes aggressive tax planning in the following terms:

Planning involving a tax position that is tenable but has unintended and unexpected tax revenue consequences; and

Taking a tax position that is favourable to the taxpayer without openly disclosing that there is uncertainty whether significant matters in the tax return accord with the law.<sup>95</sup>

This definition uses opaque terms, is open-ended and is designed to maximise revenue collection. For example, if a tax position causes unintended consequences, this does not convert something that is unobjectionable into something else. A noteworthy aspect of the OECD definition is the concession that aggressive tax planning involves taking a tax position that is 'tenable'.

Freedman, Loomer and Vella are critical of the OECD definition and say:

[A]ggressive tax planning ... and this definition specifically, are ... highly contentious ... the fact that the tax revenue consequences of a transaction are not those that the revenue authorities expected does not mean that they are not those that the legislature acting as a body expected and, moreover, that

<sup>92</sup> David F Williams, 'The Concept of Tax Governance' above n 53.

<sup>93</sup> K Fitzpatrick, 'The Australian Taxation Office's Approaches to Aggressive Tax Planning' (Speech delivered at the Centre for Tax System Integrity 3<sup>rd</sup> International Research Conference 'Responsive Regulation: International Perspectives on Taxation', Canberra, 24–25 July 2003).

<sup>94</sup> OECD, *Study into the Role of Tax Intermediaries* (14 March 2008) 11 ('*Tax Intermediaries*').

<sup>95</sup> OECD, *A Framework for Voluntary Code of Conduct for Banks and Revenue Bodies*, above n 113, [3.1.3.1].

the test of whether tax planning is ‘acceptable’ should be what the legislation says as interpreted by the courts and not what the tax authorities suppose it was intended to say.<sup>96</sup>

Broad and vague definitions only make an already complex area of law even more difficult.

McBarnet describes avoidance as ‘creative compliance’, whereby taxpayers find “[w]ays to accomplish compliance with the letter of the law while totally undermining the policy behind the words”.<sup>97</sup> There are objective factors that must be met before a company falls foul of the anti-avoidance rules and particularly the GAAR. Policy does not play a significant role here.

McBarnet says: “A tax planning device may fail in court without being branded a tax fraud. It is an essential element — and attraction — of creative compliance that it can claim to be ‘not illegal’, to be quite distinct from non-compliance”.<sup>98</sup> Avoidance is neither criminal nor compliance; it falls between the two. The anti-avoidance rules provide that if the criteria they prescribe are met, certain consequences follow.

McBarnet also suggests that economic elites with the resources to buy legal creativity can also buy immunity from the law.<sup>99</sup> That a corporation can afford to pay for advice on structuring transactions in the most tax effective way is not the problem. The only issue is whether all tax required by law is paid. It is not immoral, unethical or illegal to structure a transaction to ensure no more tax is paid than is prescribed by law. To argue that paying for advice to ensure one complies with the law is in some way reprehensible is unfounded.

Fraser notes that the line between that which is and is not taxable is an intellectual boundary; however, in the absence of a relevant judicial decision, there may be no consensus as to where that line lies.<sup>100</sup> Fraser continues:

[T]he taxpayer’s only legitimate expectation is, *prima facie*, that he will be taxed according to statute, not ... a wrong view of the law ... Why then should the expectations of the taxing authority be relevant to directors’ behaviour, to the point where the disappointment of such expectations might be regarded as giving rise to some kind of sanction?<sup>101</sup>

Fraser’s view appears to be a correct reflection of how directors should approach decisions relating to tax. Taxpayers should not have to pay more tax than is provided by law to comply with what may be an improper demand or an incorrect view of the law by the regulator unless it is in the interests of the corporation to do so.

<sup>96</sup> Freedman, Loomer and Vella, ‘Corporate Tax Risk and Tax Avoidance’, above n 82, 75–6.

<sup>97</sup> Doreen McBarnet, ‘When Compliance is Not the Solution but the Problem: From Changes in Law to Changes in Attitude’ in Valerie Braithwaite (ed), *Taxing Democracy* (Ashgate Publishing, 2002) 229.

<sup>98</sup> *Ibid* 232.

<sup>99</sup> Doreen McBarnet, ‘Legitimate Rackets: Tax Evasion, Tax Avoidance, and the Boundaries of Legality’ *Journal of Human Justice* (Spring 1992) 3(2) 56, 73.

<sup>100</sup> Ross Fraser, ‘Aggressive Tax Behaviour and Corporate Social Responsibility: A Response’ in J Freedman (ed), *Beyond Boundaries: Developing Approaches to Tax Avoidance and Tax Risk Management* (Oxford University Centre for Business Taxation, 2008) 139, 141.

<sup>101</sup> *Ibid* 144.

The ATO appears (in principle) to acknowledge the validity of Fraser's view. Hamilton says:

One experienced tax auditor said to me that a number of large clients appear to 'sit just behind the dam wall'. We can usefully think of that dam wall as the bar or line where acceptable tax planning becomes unacceptable tax avoidance, where tax positions transit to become more 'highly contestable'. Clients, advisers and the regulator may have very different views on where that line is.<sup>102</sup>

The above passage acknowledges the distinction between tax planning and avoidance and that there may be different but legitimate views of how the law operates or whether the boundary to avoidance has been crossed. A contestable arrangement may not be capable of successful challenge by the Commissioner, but companies may nevertheless be persuaded from entering into such transactions. This suggests that the Commissioner seeks to maximise the collection of revenue. Hamilton notes that in cases of two different but reasonably arguable positions owing to ambiguity in the legislation, the ATO will choose an interpretation that lowers taxpayer compliance costs.<sup>103</sup> This intimates that a correct view of the law may not always be the approach followed.

The Privy Council in *O'Neil* notes that referring to something as 'tax mitigation' or 'avoidance' is unhelpful because this "describes a conclusion, rather than providing a signpost to it".<sup>104</sup> An answer may well depend on which fact or facts the court considers to dominate a particular matrix of facts.<sup>105</sup> As the Privy Council in *Peterson* notes, "not every tax advantage comes within the scope of the section; only those which constitute tax avoidance as properly understood do so".<sup>106</sup> This principle is of application to Australia.

The views of Fraser and the Privy Council in *O'Neil* and *Peterson* are accurate expositions of the problem faced when considering the distinction between tax planning (whether it is aggressive or otherwise) and avoidance. Since the decision in *Spotless*, it has been accepted that taxpayers can arrange their affairs to minimise the extent of their tax obligations, provided their actions do not bring them within the ambit of the anti-avoidance rules.<sup>107</sup>

Even if a tax mitigation scheme is incapable of successful challenge by the Commissioner, the reduction in tax must be greater than the direct and indirect costs of implementing the scheme. These costs include any potential costs of litigation with the ATO, possible reputational damage, possible civil or criminal penalties and what Sartori describes as 'implicit taxes'.<sup>108</sup> Implicit taxes emerge when, after having minimised the tax rate, the rate of return of investments is lower than would have been the case with the higher tax rate. Tax mitigation should not reduce the net after-tax return of a transaction.

<sup>102</sup> Stuart Hamilton, 'New Dimensions in Regulatory Compliance — Building the Bridge to Better Compliance' (2012) 10(2) *eJournal of Tax Research* 483, 505.

<sup>103</sup> *Ibid.*

<sup>104</sup> *O'Neil v Commissioner of Inland Revenue* (2001) 20 NZTC 17,051, 17,057 [9] (Lord Hoffmann).

<sup>105</sup> *BP Australia Ltd v FC of T* [1965] 3 ALL ER 209.

<sup>106</sup> *Peterson v Commissioner of Inland Revenue* (2005) 22 NZTC 19098, 19109.

<sup>107</sup> *FCT v Spotless Services Ltd* (1996) 186 CLR 404.

<sup>108</sup> Sartori, above n 111.

Bersten believes that the potential costs of schemes to be considered by directors include the possibility of a reduction in the market value of the company due to adverse publicity, the time value of money and whether the transaction would compel the Commissioner to challenge the view taken by the taxpayer. Bersten notes that media controversy can arise from a surprise disclosure of a major tax risk, but that disclosure prior to the issue of an amended assessment appears generally to pass without criticism.<sup>109</sup>

This section has shown that tax planning, regardless of how it is described, is a legitimate activity of corporate taxpayers, provided actions taken do not stray into the realms of avoidance. A company that actively seeks to minimise its tax payable to the amount provided by law does not act either immorally or illegally. The problem is to identify, if possible, the boundary between tax planning and tax avoidance. If there is any doubt, the transaction should not proceed. Conduct may well be found to be compliant despite the ATO initially thinking otherwise.

Both tax planning and tax avoidance aim to reduce an entity's tax liability. Neither is illegal; however, as Lord Denning notes in *Re Weston's Settlements*, "The avoidance of tax may be lawful, but it is not yet a virtue".<sup>110</sup>

The use of the adjective 'aggressive' is not helpful in constructing a regulatory conversation with taxpayers regarding tax compliance. More specific guidance on this matter should be provided by the legislature.

## 5. CONCLUSION

As this article has demonstrated, no meaning can be ascribed to the terms 'a fair share of tax' or 'good corporate citizenship'. They are emotive and subjective with possible political overtones designed to induce corporate taxpayers to act in a manner that may be inimical to the corporations' interests.

Ethical CSR is obligatory; any other form of CSR should not be embarked upon, unless it can be expected to bring a positive, albeit not necessarily an immediate, advantage to the corporation.

The Commissioner should refrain from making statements or calls such as those considered above, as they cannot be enforced and only add to the difficulty directors face in complying with the tax laws. The Commissioner's role is to administer the law. The Commissioner should not seek to oversee some ill-defined concepts such as 'fairness' or 'good corporate citizenship'.

Further, even though the article has not made a comprehensive review of directors obligations, calls by the Commissioner for corporate taxpayers to pay what is described as a 'fair share of taxes' or other similar or analogous requests may be a call for corporate taxpayers to pay more tax than that mandated by law. This may also be an unintentional, assumption by the Commissioner to impose taxes or to increase the rate of taxation – something beyond his powers.

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<sup>109</sup> M Bersten, 'Managing Risks in a Tax Audit — The Tax Man Cometh' (Paper delivered at the 45<sup>th</sup> Victorian State Convention of the Taxation Institute of Australia, Victoria, 6 October 2006).

<sup>110</sup> *Re Weston's Settlements* [1968] 3 All ER 338, 342.

Aggressive tax planning suffers from the same problems. It is a conclusion which does not indicate how one could ever identify, with certainty, what is 'aggressive tax planning'. It may be a stratagem to persuade taxpayers from embarking on tax mitigation schemes that cannot be challenged. If this is the case, it is beyond the powers of the Commissioner.

There is, in the author's opinion, no basis for calls such as those described in this article. They add an emotive, subjective and political dimension to the administration of the tax laws. A Corporation's tax liability should be capable of objective determination in accordance with the law. Any other basis could make compliance subject to the subjective determination of others.<sup>111</sup>

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<sup>111</sup> The Constitutional consequences of this are beyond the scope of this article.

# Factors Influencing taxpayers' compliance with the tax system: An empirical study in Mekelle City, Ethiopia

Tadesse Getacher Engida<sup>1\*</sup>, and Goitom Abera Baisa<sup>1</sup>

## **Abstract**

This paper attempted to reveal determinants of taxpayers' compliance with the tax system. Nine tax compliance determinants were examined; the examined tax compliance determinants were: probability of being audited; perception of government spending; perception of equity and fairness; penalty, financial constraint; changes to current government policies; referral group; the role of the tax authority; and tax knowledge. The study used a cross-sectional survey method of research design. Given the scaled ranking information of the dependent variable (tax compliance), an ordered probit was applied to examine determinants of tax compliance in Mekelle city, Ethiopia. The study results from the survey conducted in Mekelle using 102 respondents, indicate that tax compliance was influenced by the probability of being audited, financial constraints, and changes in government policy. The results of this study can inform policymakers how the determinants influence tax compliance behaviour. The analysis focuses on tax compliance and its determinants and is therefore subject to an underlying assumption of tax payers' understanding of tax and other potentially relevant information. The results of this study also provide specific insights and allow policy makers to gain a better understanding of the key variables that are significantly associated with tax compliance and enable them to implement suitable strategies to minimise potentially damaging factors, and should also allow them to improve their government's tax revenue collections. Tax collection is evidenced to be low in the country; hence, studying the factors influencing tax compliance is of enormous significance. Such a study becomes imperative given limited research so far undertaken in the area. Moreover, this study attempts to enrich the existing literature by providing a clearer picture and a holistic view of taxpayers' compliance behaviour from a developing country's perspective.

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<sup>1</sup> College of Business and Economics, Mekelle University, Ethiopia.

\*Corresponding author. E-mail: ahadu3xx@gmail.com



## 1. INTRODUCTION

Tax non-compliance is a serious challenge slackening income tax administration and tax revenue performance in Ethiopia, as it does in some other developing countries. Like other developing countries, Ethiopia faces hurdles in raising revenue to the required level in order to scale up the development endeavours. Ethiopia has experienced an unswerving surplus expenditure over revenue for a sufficiently long period of time. To address this problem, the government introduced direct and indirect taxes to improve public revenue although prior statistical evidence proves that the contribution of income taxes to the government's total revenue remained consistently low.

The tax compliance literature has provided evidence suggesting that compliance is influenced by numerous factors (Brook, 2001). Scholars identified these factors as economic, social and psychological (Brook, 2001; Devos, 2008; Kirchler, 2007). To mitigate the challenge of tax non-compliance, it is necessary to understand factors influencing an individual's decision to comply with tax laws.

According to Kirchler (2007) and Loo (2006), tax compliance determinants are classified in four categories based on an interdisciplinary perspective representing a wider perspective of tax compliance determinants compared to other researchers. The four categories are 1) economic factors (tax rates, tax audits and perceptions of government spending); 2) institutional factors (the role of the tax authority, simplicity of the tax returns and administration and probability of detection); 3) social factors (ethics and attitude, perceptions of equity and fairness, political affiliation and changes on current government policy, referent groups); and 4) individual factors (personal financial constraints, awareness of offences and of penalties).

The extent of the effect of the factors influencing tax compliance is not well understood and studies have not been carried out in Mekelle city, Ethiopia to the best of the authors' knowledge. Therefore, examining economic, institutional, social, individual and selected demographic factors that influence tax compliance behaviour in Mekelle city, Ethiopia is the primary purpose of this study.

## 2. THEORETICAL FRAMEWORK AND HYPOTHESES

The following is a brief review of the literature with regard to the determinants of tax compliance behaviour.

### 2.1 Economic factors

Economic factors in relation to tax compliance refer to actions which are associated with the costs and benefits of performing the actions (Loo, 2006). Hasseldine (1993), and Song and Yarbrough (1978) assumed that taxpayers are rational economic evaders who likely would assess the costs and/or benefits of evasion. The tax compliance determinants associated with economic factors such as tax rates, tax audits and perceptions of government spending are explored in more detail.

### 2.1.1 *Tax audits*

Some studies claimed that audits have a positive impact on tax evasions (Jackson and Jaouen, 1989; Shanmugam, 2003; Dubin, 2004). These findings suggest that in self assessment systems, tax audits can play an indispensable role and their essential role is to increase voluntary compliance. Frequencies and meticulousness of audits could encourage taxpayers to be more prudent in completing their tax returns, reporting all income and claiming the correct deductions to ascertain their tax liability. In contrast, taxpayers who have never been audited might be tempted to under report their actual income and claim false deductions.

*Hypothesis 1*— Probability of being audited is positively correlated with tax compliance.

### 2.1.2 *Perceptions of government spending*

Taxpayers, and especially those who pay high amounts of tax, will be sensitive to what the government spends their money on. If the government is wisely spending the national revenue, for example, for basic facilities like education, health and safety and public transportation, it is likely that voluntary compliance will increase. In contrast, if taxpayers perceive that the government is spending too much on something considered unnecessary or unbeneficial to them, then taxpayers will feel betrayed and attempt to evade.

*Hypothesis 2* — Positive perception of government spending is positively correlated with tax compliance.

## 2.2 **Institutional factors**

While taxpayers are influenced by their pure economic concerns either to evade or not to evade taxes, evidence suggests that institutional factors also play vital role in their compliance decisions.

### 2.2.1 *Role (efficiency) of the tax authority/government*

For many aspects of tax compliance, there is a debate in literature as to how the effective operation of the tax system by the tax authorities influences taxpayers' compliance behaviour. The role of the tax authority in minimising the tax gap and increasing voluntary compliance is clearly very important. Hasseldine and Li (1999) illustrated tax compliance is placing the government and the tax authority as the main party that need to be continuously efficient in administering the tax system in order to curtail tax evasion. Besides, the study of Richardson (2008) also suggested that the role of a government has a significant positive impact on determining attitudes toward tax.

*Hypothesis 3* — The role (efficiency) of the tax authority is positively correlated with tax compliance.

## 2.3 Social factors

Tax compliance determinants from a social perspective relates to taxpayers' willingness to comply with tax laws in response to other people's behaviour and their social environment (i.e. the government, friends and family members) (Torgler, 2007). On the other hand, Kirchler (2007) suggested that social factors should be viewed in a broader sense than Torgler's perspective; this includes the psychology of the taxpayers. The factors discussed in this section are therefore perceptions of equity and fairness, changes to current government policy and referent groups.

### 2.3.1 *Perceptions of equity or fairness*

One of the main principles of the taxation system design is equity or fairness, which can be perceived via three dimensional views – horizontal equity (people with the same income or wealth brackets should pay the same amount of taxes), vertical equity (taxes paid increase with the amount of the tax base) and Exchange Equity (Wallschultzky 1984; Richardson, 2006). The perceived fairness of the tax system also has an influence on the inclination towards tax evasion (Jackson and Milliron, 1986; Richardson, 2008).

*Hypothesis 4* — Positive perception of equity in the tax system is positively correlated with tax compliance.

### 2.3.2 *Changes to current government policies*

Political stability and the ruling party in a country might play a significant role in determining tax evasion behaviour. For instance, if an individual favours the ruling party, he might choose to be compliant because he believes that the government is trusted, efficient and equitable. Conversely, a taxpayer from the opposition party might be more non-compliant because he perceives that the government is not on his side. Studies have disclosed that the government decisions and changes to policies in accordance with the economic and political situation have a significant impact on compliance. For example, a positive move made by the government such as an increase in tax rebate (Hasseldine and Hite, 2003) is likely to increase taxpayers' compliance.

*Hypothesis 5* — Unfavourably perceived changes to current government policies are negatively correlated with tax compliance.

### 2.3.3 *Referent groups (family and friends)*

Research in ascertaining the importance of referent groups such as family members and friends in tax compliance is limited although Ajzen and Fishbein (1980) (in their Theory of Reasoned Action (TRA) and Theory of Planned Behaviour (TPB)) theorised that referent groups play a significant role in determining people's intentions and behaviour. Decisions either to evade or not to evade tax sometimes are influenced by family members or friends (for example, Allingham and Sandmo (1972)) although the extent of the influence

was not clearly stated in this research. Therefore, the influence of referent groups is seemingly important in making a decision, particularly involving monetary aspects and the obedience to laws (tax compliance).

*Hypothesis 6* — The influence of referent group is positively correlated with tax compliance.

## 2.4 Individual factors

Decisions either to evade or not to evade taxes are heavily reliant on taxpayers' personal judgment (Mohani, 2001). Personal circumstantial factors like personal financial constraints and awareness of penalties and offences are therefore likely to have a significant impact on taxpayer compliance behaviour.

### 2.4.1 Personal financial constraints

Personal financial constraints are believed to have an impact on tax evasion as financial distress faced by an individual and may encourage him to prioritise what has to be paid first as basic survival needs (foods, clothing, housing etc.) or where immediate demand on limited income is enforced (for example, perceived threat of action from money lenders etc.) rather than tax liabilities. People who face personal financial problems are likely to be more prone to evade tax when compared to people in less financial distress (Mohani and Sheehan, 2004; Mohani, 2001).

*Hypothesis 7* — Personal financial constraint is negatively correlated with tax compliance.

### 2.4.2 Awareness of offences and penalties

A theoretical economic model introduced by Allingham and Sandmo (1972) has clearly indicated that penalties as well as audit probability have an impact on tax compliance. The higher the penalty and the potential audit probability the greater the discouragement for potential tax evasion. If the taxpayers are aware of the offences they are committing when evading tax and the consequences of being non compliant taxpayers, they might reduce their tendency to evade tax.

*Hypothesis 8* — Awareness of penalty is positively correlated with tax compliance.

### 2.4.3 Tax knowledge

The influence of tax knowledge on compliance behaviour has been described in various researches. The level of education received by taxpayers is an important factor that contributes to the understanding about taxation especially regarding the laws and regulations of taxation (Eriksen and Fallan, 1996). Previous studies have evidenced that tax knowledge has a very close

relationship with taxpayers' ability to understand the laws and regulations of taxation, and their ability to comply (Singh and Bhupalan, 2001).

*Hypothesis 9* — Tax knowledge is positively correlated with tax compliance.

## **2.5 Demographics and other control variables**

### **2.5.1 Gender**

Some studies found that males are more compliant though other studies revealed contradictory results or no significant difference at all. As agreements on the findings still maintain, the need to explore current results is relevant. Hasseldine and Hite (2003) found that female taxpayers were more compliant than males. However, the study reported that males were more compliant compared to females when a negatively framed message was used, and females were more compliant than males when a positively framed message was used. In contrast, Richardson (2006) suggested that gender has no significant impact on compliance across a study of 45 countries.

*Hypothesis 10* — Male tax payers are more tax compliant.

### **2.5.2 Income**

Jackson and Milliron (1986) found that income level has a mixed and unclear impact on compliance, and some later research agrees with that statement (see Christian and Gupta, 1993; Hite, 1997). Although Jackson and Milliron (1986) did not clearly mention the reason, it is presumed that endogenous tax regulations among countries might contribute to inconsistent findings. For example, progressive tax rates might encourage the higher income group to evade rather than the lower income group because their (higher income group) tax rates and taxable income are high, thus, making the tax liabilities much higher than lower income group. In a country where income redistribution is not satisfying, the higher income group tends to evade more (Mohani, 2001) because the high income earner might feel betrayed and unfairly treated. Loo (2006) found that high income earners in Malaysia are prone to evading tax while Torgler (2007) reported that lower income earners in Western Germany were less compliant.

*Hypothesis 11* — Higher income level is positively associated with better tax compliance.

### **2.5.3 Age**

Demographic factors like age have long been researched by many researchers and findings are different along the way. For example Tittle (1980), Warneryd and Walerud (1982) and Wahlund (1992) posit negative association — older people are less compliant.

In contrast, Dubin, Graetz and Wilde (1987), Chung and Trivedi (2003) and Beron, Tuachen and Witte (1992) argued that age was positively related with compliance. However, there have been a significant number of studies which found no relationship between age and compliance (Spicer and Becker 1980 and Porcano, 1988). Mohani 2001 also found that older people are more compliant.

*Hypothesis 12* — Older tax payers are tax compliant.

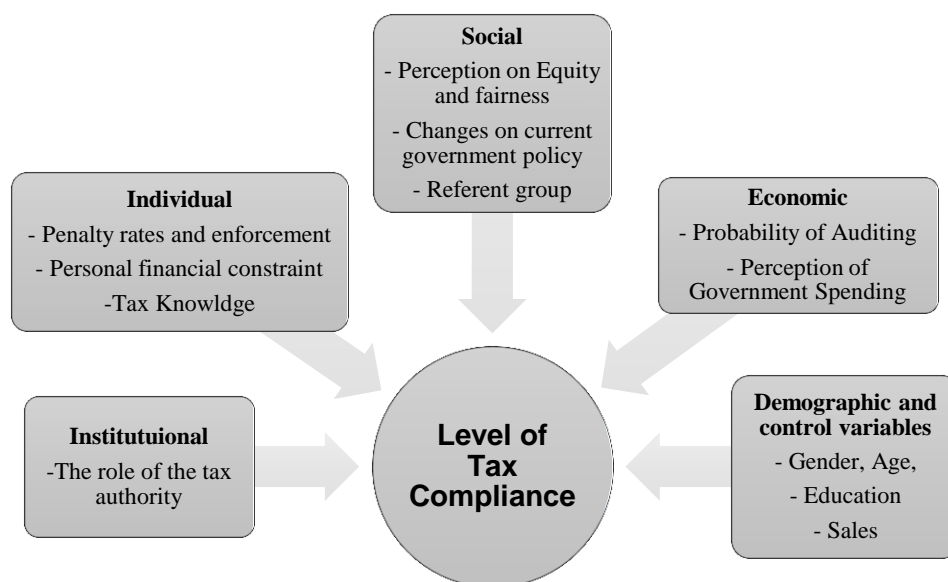
#### 2.5.4 Education

Previous literature supports the direct, positive relationship between educational level and taxpayer compliance (Jackson and Miliron 1986). Chan, Troutman, and O'Bryan (2000) also postulate that education level is directly linked to a likelihood of compliance. Educated taxpayers may be aware of non-compliance opportunities, but their potentially better understanding of the tax system and higher level of moral development promote a more favourable taxpayer attitude and greater compliance.

*Hypothesis 13* — Educational level has direct relationship with tax compliance.

The schematic presentation of the theoretical framework identified for this study purpose is presented below:

**Figure 1: The description of variables and expected effect of the determinant and control variables**



Source: Own construct

The following comprises a brief review of the literature with regard to the variables mentioned earlier.

**Table 1: Variables description and expected associations with the level of tax compliance**

Variables	Symbols	Unit of measurement	Expected signs/hypotheses
<i>Dependant Variables</i>			
Level of compliance	Compliance_Stat	<b>(1,2,3) Ordinal</b>	
<i>Independent Variables</i>			
Tax knowledge	Tax_knowldge	<b>(1,2,3) Ordinal</b>	+ (high tax knowledge, high compliance)
Probability of Auditing	Prob_Audi	(1-5 Likert Scale) Ordinal	+(high probability, high compliance)
Perception of Government Spending	Gov_Spend	(1-5 Likert Scale) Ordinal	+ (good perception, high compliance)
Perception on Equity and fairness	Equity_Fair	(1-5 Likert Scale) Ordinal	+ (good perception, high compliance)
Penalty rates and enforcement	Penalty	(1-5 Likert Scale) Ordinal	+ (High penalty, high compliance)
Personal financial constraint	Fina_Cons	(1-5 Likert Scale) Ordinal	- (crucial financial problem, low compliance)
Changes on current government policy	Gov_Policy	(1-5 Likert Scale) Ordinal	- (Changes to government policies, lower compliance)
Referent group	Referall	(1-5 Likert Scale) Ordinal	+ (high influence, high compliance)
The role of the tax authority	RCA_Role	(1-5 Likert Scale) Ordinal	+ ( High efficiency of tax authority, Higher Compliance)
Gender	Gender	(0-1) binary	- ( Female= 0, higher compliance)
Income /Sales	Sales	<b>(1-7) Ordinal</b>	+ ( High income, Higher Compliance)
Age	Age	<b>(1-8) Ordinal</b>	+ ( Aged tax payers, Higher Compliance)
Education level	Educ	<b>(1-6) Ordinal</b>	+ ( Aged tax payers, Higher Compliance)

### 3. METHODOLOGY

#### 3.1 Method

In order to have a better understanding of the situation and gather pertinent data, a survey method of data collection was employed. A structured questionnaire was distributed to 102 Category C taxpayers in three sub-cities of Mekelle, namely Semen, Hawiliti and Adi-haki. The study was carried out on Category C taxpaying business enterprises, whose annual turnover is not more than 100,000 birr. The motivation of considering Category C is that taxpayers in this group are considered hard to tax because the law doesn't require them to declare their income or keep books of account. Therefore, it can be said that they are non-compliant with the tax system owing to the absence of documenting their inventories and disclosure of their earnings.

#### 3.2 Model

Tax compliance is measured through five items: the intention to evade paying tax, the intention to exaggerate deductions, how one feels about not evading income tax, how one feels about not exaggerating deductions, and the acceptability of tax evasion. For instance, acceptability of tax evasion can be measured by: "I wouldn't feel bad if I don't pay tax" (1 = completely agree, 5 = completely disagree). The average score over the five items will be taken as an index for tax compliance. Based on this score, taxpayers were categorized into three levels of compliance: low, medium, high. Given the scaled ranking information of the dependent variable, ordered logistic estimation is applied. The ordered logistics have the following form:

$$y_i^* = \beta_0 + x_{1i}\beta_1 + x_{2i}\beta_2 \dots x_{ki}\beta_k + \varepsilon_i$$

$$y_i^* = x_i\beta + \varepsilon_i$$

where  $y_i^*$  is the dependant variable (levels of compliance);  $\beta$  is the vector of estimated parameters and  $x_i$  is the vector of explanatory variables;  $\varepsilon_i$  is the error term, which is assumed to be normally distributed (zero mean and unit variance).

$Y_i$ , the observed ordinal variable, takes on values 0 through m according to the following scheme:

$$y_i = j \Leftrightarrow \mu_{j-1} < y_i^* \leq \mu_j', \text{ Where } j=0, \dots, m.$$

Like the models for binary data, the study is concerned with how changes in the explanatory variables transform into the probability of observing a particular level of compliance. Accordingly, the probability of each tax compliance level (low- $y_1$ , medium- $y_2$ , and high- $y_3$ ) will be computed as follows:

$$y_i=1 \quad \text{if} \quad y_i^* \leq u_1$$

$$y_i=2 \quad \text{if} \quad u_1 < y_i^* \leq u_2$$

$$y_i=3 \quad \text{if} \quad y_i^* > u_2$$



## 4. RESULTS

Nine variables were tested using ordered logistic regression, namely the probability of being audited, perception of government spending, perception of equity and fairness, penalties, financial constraints, changes to current government policy, roles of referent groups, roles of the tax authority and tax knowledge.

### 4.1 Correlation among variables

Table 2 illustrates the Spearman correlation matrix for dependent and independent variables. Based on Table 2, all independent variables except for Tax knowledge, Gov\_Spend and RCA\_Role were significantly correlated with Compliance Stat. The highest correlation occurred between compliance stat and Prob\_Audi ( $r_s = -.38$ ) followed Equity\_Fair, Referral1, Gov\_Policy, Fina\_Cons and Penalty. According to univariate results in Table 2, it was suggested that Prob\_Audi, Equity\_Fair, Penalty, Fina\_Cons, Gov\_Policy and Referral1 were the most significant determinants.

**Table 2: Spearman correlation matrix for dependent, independent variables**

	1	2	3	4	5	6	7	8	9	10
1. Compliance_Stat	1									
2. Tax_knowledge	0.09	1								
3. Prob_Audi	0.38(***)	0.07	1							
4. Gov_Spend	0.03	-0.19(*)	-0.15	1						
5. Equity_Fair	0.30(***)	-0.13	0.5314 (***)	-0.16	1					
6. Penalty	-0.19(*)	0.10	0.20 (**)	-0.16	0.03	1				
7. Fina_Cons	-0.21(**)	0.01	0.16	0.01	0.15	0.23 (**)	1			
8. Gov_Policy	-0.25 (**)	0.11	0.37 (***)	-0.17 (*)	0.34 (***)	0.10	0.18 (*)	1		
9. Referral1	-0.30 (***)	0.16	0.47 (***)	-0.15	0.31 (***)	0.29 (***)	0.04	0.12	1	
10. RCA_Role	-0.13	0.04	0.10	0.01	0.03	0.31 (***)	0.23(**)	-0.14	0.25 (**)	1

Notes: \*\*\* $p < 0.01$ , \*\* $p < 0.05$ , \* $p < 0.1$ .

### 4.2 Factors affecting tax compliance

#### 4.2.1 Determinants of tax compliance — ordered Logistic regression result

Based on Table 3, ordered logistic regression analysis indicates that the factors affecting tax compliance were Probability of auditing, personal financial constraint, and changes on current government policy. Probability of auditing appears to be the main factor in determining tax compliance behaviour with Beta of  $-0.31$  followed by Personal financial constraint, Changes on current government policy with Beta coefficient of  $-0.25$ , and  $-0.26$  respectively.

Regarding variables such as financial constraints and unfavourably perceived changes in current government policy which were described in terms of price fluctuation on the commodities that are subsidised by the government, the result portrayed taxpayers do not comply with the tax system when they face a stalemate because of financial constraints and unfavourable rise or dwindle in price. On the other hand, higher

probability of being audited tends to increase compliance among taxpayers. These results also suggest that other variables such as perception of government spending, perception of equity and fairness, penalties, roles of the tax authority, and tax knowledge were not significantly correlated with tax compliance.

**Table 3: Determinants of tax compliance — ordered logistic regression result**

Variable	Coef.	SE	Z
Tax knowledge	0.68	0.45	1.51
Probability of Auditing	0.31(*)	0.18	-1.72
Perception of Government Spending	-0.1	0.14	-0.72
Perception on Equity and fairness	-0.1	0.17	-0.56
Penalty rates and enforcement	-0.14	0.17	-0.83
Personal financial constraint	-0.25(*)	0.15	-1.71
Changes on current government policy	-0.26(*)	0.15	-1.78
Referent group	-0.21	0.17	-1.29
The role of the tax authority	-0.09	0.13	-0.66
Log likelihood	-75.36928		
LR chi2(23)	29.2		
Number of obs	99		

Notes: \*\*\*p <0.01, \*\*p <0.05, \*p <0.1.

#### 4.2.2 Tax compliance determinants with control variables

This section investigates the effect of inserting control variables into the analysis of tax compliance behaviour and examines whether these control variables in the ordered logistic regression produce a better explanatory value.

Table 4 illustrates the spearman correlation matrix for dependent, independent and control variables. There were a number of significant correlations between level of tax compliance and independent variables. Except Tax\_knowldge, Gov\_Spend, RCA\_Role, and Educ, ten explanatory variables were significantly correlated with level of tax compliance. This outcome proves that most of the determinants tested are associated with the level of tax compliance.

**Table 4: Spearman correlation matrix for dependent, independent variables and control variables**

	1	2	3	4	5	6	7	8	9	10	11	12	13	14
1. Compliance_Stat	1													
2. Tax_knowledge	0.06	1												
3. Prob_Audi	0.37 (***)		1											
4. Gov_Spend	0.05	-0.16	-0.17(*)	1										
5. Equity_Fair	-	0.29(***)	-0.12	0.53 (***)	-0.18(*)	1								
6. Penalty	-0.18(*)	0.12	0.19(*)	-0.17(*)	0.03	1								
7. Fma_Cons	-0.20(**)	0.03	0.15	0	0.14	0.22(**)	1							
8. Gov_Policy	-0.23(**)	0.14	0.36(***)	0.20(**)	0.33(***)	0.1	0.16	1						
9. Referral	0.31(***)	0.15	0.48(***)	-0.15	0.32(***)	0.30(***)	0.04	0.13	1					
10. RCA_Role	-0.14	0.03	0.11	0.02	0.03	0.31(***)	0.24(**)	-0.13	0.24(**)	1				
11. Gender	-0.25(**)	-0.18(*)	0.05	-0.06	0.16	0.08	0	-0.01	0.05	0.03	1			
12. Sales	-0.23(**)	-0.13	-0.03	0	0.13	0.08	0.21(**)	0.03	-0.07	0.17(*)	0.16	1		
13. Age	-0.25(**)	-0.01	0.04	0.03	0.07	-0.08	0.15	0.08	-0.14	0.09	0.05	0.20(**)	1	
14. Educ	-0.01	-0.08	-0.08	-0.1	-0.04	0.18(*)	-0.04	-0.12	0.11	0.04	0.18(*)	0.05	0.26(**)	1

Notes: \*\* \*p < 0.01, \*\* p < 0.05, \*p < 0.1.

Table 5 summarises the results of the supplementary regression model which incorporated several control variables. The ordered logistic regression analysis indicates probability of auditing, personal financial constraint, changes on current government policy, gender and age are determinants of tax compliance. This supplementary regression model also suggested that Probability of Auditing, Personal financial constraint, changes on current government policy remain the most important determinants of tax compliance.

In relation to the significance of the control variables, results show that Gender and age appear to be significantly correlated with tax compliance behaviour. Specifically, the association between gender (male=1) and compliance status was negative and significant ( $p < 0.05$ ), rejecting the hypothesis that male taxpayers are significantly less compliant.

The association between age and compliance status was negative and significant ( $p < 0.05$ ), consequently, the hypothesis that older people are significantly more compliant is not accepted.

Finally, other control variables like income and education had no significant association with compliance status.

Again, analogous to results in Table 5, these results verified that control variables had a significant impact on increasing tax compliance behaviour. Furthermore, results demonstrated that the supplementary regression model remains robust.

**Table 5: Determinants of tax compliance — ordered logistic regression result with control variables**

Variables	Coeff.	SE	Z
Tax knowledge	0.50	0.49	1.01
Probability of Auditing	0.32 (*)	0.18	-1.80
Perception of Government Spending	-0.09	0.16	-0.60
Perception on Equity and fairness	0.01	0.18	0.04
Penalty rates and enforcement	-0.14	0.18	-0.78
Personal financial constraint	-0.24(*)	0.15	-1.56
Changes on current government policy	-0.25(**)	0.16	-1.59
Referent group	-0.38	0.18	-2.11
The role of the tax authority	-0.04	0.14	-0.26
Gender	-1.08 (**)	0.52	-2.07
Sales (Income)	-0.09	0.12	-0.78
Age	-0.51 (***)	0.18	-2.82
Educ	-0.13	0.16	-0.77
Log likelihood	-67.138657		
LR chi2(23)	42.71		
Number of obs	98		

Notes: \*\*\*p <0.01, \*\*p <0.05, \*p <0.1.

## 5. DISCUSSION

This research is geared towards examining factors that affect taxpayers' behaviour in Mekelle, Ethiopia. Nine potential determinants of tax compliance were examined in this study, namely the probability of being audited, perceptions of government spending, perceptions of equity and fairness, penalties, financial constraints, changes to current governmental policies, the impact of referral groups, the role of the RCA and tax knowledge.

The findings imply that the significant factors affecting tax compliance in Mekelle at the time of this study include the probability of being audited (positive), financial constraints (negative) and changes on current government policy (negative) (refer to Table 3). The probability of being audited was found to be the main explanatory factor in determining tax compliance behaviour, followed by changes on current government policy and financial constraints (refer to Table 3 and Table 5).

These results provide evidence that taxpayers who have crucial financial constraints and changes on current government policy would tend to be less compliant (negative association). Besides, a high probability of being audited would tend to be more compliant (positive).

These results also suggest that other variables such as perception of government spending, perception of equity and fairness, penalties, roles of the tax authority and tax

knowledge were not significantly correlated with tax compliance at the time of this study.

With regard to the probability of being audited, previous studies (for example, Allingham and Sandmo (1972); Jackson and Jaouen (1989); Wickerson (1994); Shanmugam (2003); Dubin (2004); Riahi-Belkaoui (2004); Richardson (2006); Andreoni, Erard and Feinstein (1998); Verboon, and van Dijke (2007); Eisenhauer (2008)) have found that a high probability of being audited or detected would encourage taxpayers to be more compliant (positive relationship) but some other studies found contradicting results, such as a high probability of being audited would potentially decrease compliance creating a negative association (for example Slemrod, Blumenthal, and Christian, (2001); Braithwaite, Reinhart, and Smart, (2009)). As far as high probability of audit could encourage tax compliance, it is advocated that the tax authority should increase their number of audit samples with the aim of increasing tax compliance, decreasing the tax gap and achieving the missions of RCA.

With regard to financial constraints, results of this study were concurrent with another study conducted by Mohani (2001) in Malaysia that taxpayers who faced personal financial problems were more prone to evading tax in comparison with those in less financial distress. Furthermore, this study also revealed and verified that people in financial distress would tend to prioritise their financial needs and obligations first rather than pay taxes. For example, people are likely to pay their utility bills or outstanding loans because failure to do so would result in immediate fines or actions worse than the penalty they incur under the jurisdiction of the tax authority. This statement is backed up by the results of this study, which found that penalties and the role of the tax authority were not significantly correlated with tax compliance. It demonstrates that taxpayers are not being subjected to corrective action and thus, they are not giving due consideration to making compliance decisions.

Regarding changes to current government policy which was sought to be scrutinized vis-à-vis basic needs' prices rise and fall, the study found that changes in government policy cast their shadow on tax compliance decisions. Hence, basic needs' price fluctuation had a significant impact on tax compliance behaviour. As long as the Ethiopian economy is under the influence of the global economic recession in general and the soaring price of basic needs in particular, taxpayers remain irritated when little changes emerge along with a considerable economic phenomenon. Therefore, so far as they remain vigilant about changes in government policies, and expect the most favourable condition from the government policies, they remain non-compliant to the tax system if the changes in government policies do not match their perceptions.

In this study, other variables such as perception of government spending, perception of equity and fairness, penalties, roles of the tax authority and tax knowledge were not significantly correlated with tax compliance decisions, even though previous studies in other countries found significant associations (see Harris, (1989)). For example, the role of the tax authority in minimising the tax gap and increasing voluntary compliance was found to be very important as Hasseldine and Li (1999) placed the government as the main influencing factor in relation to tax evasion. The government plays a central role through designing and enforcing the tax systems, and collecting taxes (Hasseldine and Li, 1999: 93). Spicer and Becker (1980), Andreoni *et. al.* (1998) and Wenzel (2003) claimed that if a specific group perceived their tax liability was

higher than other groups, then tax evasion might occur among the group members. At a social level, tax compliance with regards to fairness is viewed as a national concern. If taxpayers perceive that the tax system is unfair, tax evasion is more likely to occur (Allingham and Sandmo, 1972; Baldry, 1999). At a general level, however, this study did not find similar results to those found in these prior works.

Further analysis shown in table 5 found that out of four examined control variables, only two of them were negatively significant. Gender and age were significantly correlated with tax compliance (refer Table 5). Male and older taxpayers were less compliant while other control variables such as income and education level were not significant.

With regard to gender, although findings from other studies were not conclusive and a concrete solution is still being debated, this study found that female taxpayers were more compliant. Again, this study found similar results with Mohani (2001) that males are less compliant than female counterparts. Therefore, based on the results of this study and previous research, it can be concluded that female taxpayers are more compliant in comparison with males in this study area.

On the subject of age, this study found a negative association contradicting with the hypothesis and results of previous studies like those of Dubin and Wilde (1988), Loo (2006), and Torgler (2007), which asserted that age was positively related with compliance. Studies which found a negative association include Warneryd and Walerud (1982) and Wahlund (1992). There were also a significant number of studies that found no relationship (See Spicer and Becker 1980 and Porcano, 1988).

## 6. SUMMARY AND CONCLUDING REMARKS

As potential issues of tax compliance are large in number, the primary objective of this study was to examine the determinants of tax compliance in Mekelle, Ethiopia. Based on a survey conducted in Mekelle using 102 responses, an attempt was made to explain effects of compliance determinates: whether increasing the probability of being audited, improving development of perceptions of government spending, addressing personal financial constraints, decreasing negative impact of referent groups, targeting specific programmes on tax compliance based on specific profiles of gender, income, age and education levels are more likely to deliver the desired increase in voluntary compliance.

The findings indicated that tax compliance was influenced by the probability of being audited, financial constraints and changes on current government policy. Other variables such as perception of government spending, perception of equity and fairness, penalties, roles of the tax authority and tax knowledge were not significantly correlated with tax compliance at the time of this study.

The low compliance and non-compliance rates influenced the frequency of the authority's tax audit activities and the practice of imposing penalties. However, the prior literature suggest that taxpayers' compliance behaviour is not solely influenced by penalties and the frequency of tax audits, but also by their level of tax knowledge, their attitudes towards and perceptions of the tax system related to the fairness of the system and inadequacy of the tax authority's enforcement strategies (Kirchler, 2007; Torgler, 2007; Richardson, 2006).

In this study, other variables such as perceptions of equity and fairness, penalties, unfavourably perceived changes to current government policy and the role of the tax authority appear to be not significantly correlated with tax compliance decisions, even though previous studies in other countries found significant associations (see Harris, (1989). For example, the role of the tax authority in minimising the tax gap and increasing voluntary compliance was found to be very important as Hasseldine and Li (1999) placed the government as the main influencing factor in relation to tax evasion. The government plays a central role through designing and enforcing the tax systems, and collecting taxes (Hasseldine and Li, 1999: 93). Spicer and Becker (1980), Andreoni *et. al.* (1998) and Wenzel (2003) claimed that if a specific group perceived their tax liability was higher than other groups, then tax evasion might occur among the group members.

The results of this study also provide implications for the government that specific insights should allow policy makers to gain a better understanding of the key variables that are significantly associated with tax compliance and enable them to implement suitable strategies to minimise potentially damaging factors, and should also allow them to improve a government's tax revenue collections.

Further, it is recommended that this kind of study should be conducted at the national level to gain a better understanding on compliance determinates in the country.

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# Small business and tax compliance costs: A cross-country study of managerial benefits and tax concessions

Chris Evans<sup>1</sup>, Ann Hansford<sup>2</sup>, John Hasseldine<sup>3</sup>, Philip Lignier<sup>4</sup>, Sharon Smulders<sup>5</sup> and Francois Vaillancourt<sup>6</sup>

## ***Abstract***

Concern about the size and the regressive nature of taxation compliance costs for small businesses has prompted many governments to introduce special tax concessions and regimes for that sector of the economy. This article reports on exploratory research conducted in four countries (Australia, Canada, South Africa and the United Kingdom) in 2010-11 utilising broadly similar survey instruments, designed to collect and collate data about the levels of compliance costs experienced by small businesses; to identify the extent (if any) to which compliance with tax obligations may have given rise to managerial benefits; and to evaluate the use and usefulness for the small business sector of special tax regimes designed to mitigate the burden of tax compliance. In spite of some data limitations it finds remarkably similar outcomes in all four countries: tax compliance costs remain high and regressive, and do not appear to be diminishing over time; many small businesses are aware of the managerial benefits, in terms of better decision making and management of financial information that derives from tax compliance, though few are able to place a value on those benefits; and legislated small business tax concessions do not appear to be making any difference to the burden of tax compliance in the three countries that were considered in relation to that issue.

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<sup>1</sup> Professor of Taxation, UNSW Australia; corresponding author: cc.evans@unsw.edu.au

<sup>2</sup> Senior Lecturer, University of Exeter, UK

<sup>3</sup> Professor, University of New Hampshire, USA

<sup>4</sup> Lecturer, University of Tasmania, Australia

<sup>5</sup> Head of Tax Technical Policy & Research, The South African Institute of Taxation

<sup>6</sup> Fellow CIRANO and Emeritus Professor, University of Montreal, Canada

## 1. INTRODUCTION AND MOTIVATION

Taxation has a significant impact upon many sectors of the economy, and in particular upon the small business sector, considered vital for the well-being of the economy (Weichenrieder 2007, p. 4). As noted by Freedman (2003, p. 13), “[s]mall businesses are associated with entrepreneurship, economic growth and job creation”. It is therefore not surprising that governments around the world are very conscious of the heavy burden that taxation systems can impose upon the small business sector (Grainger 2008).

That taxation burden typically consists of three elements (Evans 2008, p. 447). In the first place there are the taxes themselves, whether they are taxes on the profits, the products or the employees. Secondly, there are the efficiency costs (variously referred to as deadweight losses or excess burden), involving tax-induced market distortions. And finally there are the operating costs of the tax system: the costs to the government (ultimately borne by taxpayers) of administering and collecting the taxes (usually referred to as administrative costs), and the costs expended by taxpayers in complying (or sometimes not complying – Kamleitner, Korunka and Kirchler 2012) with their tax obligations (usually referred to as compliance costs). The focus of this article is upon the latter – tax compliance costs, the so-called ‘hidden’ costs of taxation (Sandford 1995a).

Tax compliance costs are those costs “incurred by taxpayers, or third parties such as businesses, in meeting the requirements laid upon them in complying with a given structure and level of tax” (Sandford, Godwin, and Hardwick 1989, p. 10). Such costs are significant for small business taxpayers in all Organisation for Economic Cooperation and Development (OECD) tax jurisdictions (Weichenrieder 2007, p. 4). There is an extensive literature in the area (much of it summarised in Evans, 2008; and in Vaillancourt and Clemens 2008), and previous research has shown that tax compliance costs are high for this sector in absolute terms and relative to the size of the business, whether measured by reference to turnover, income, number of employees or any other proxy. The research also shows that those compliance costs do not appear to be diminishing over time (Lignier and Evans 2012; Lignier, Evans and Tran-Nam 2014). Whilst money and time spent on compliance are the items most frequently measured, small business owners may also experience anxiety and psychological costs in meeting their tax obligations (Woellner, Coleman, McKerchar, Walpole and Zetler 2001).

In response to this concern about tax compliance costs, governments have often endeavoured to implement tax policies in the form of concessions that produce favourable outcomes for the small business sector (Pope 2008, p. 14). Such special tax concessions for small business fall mainly into two categories: positive concessions that provide a lower rate of taxation, an exemption or an accelerated deduction; and relieving concessions that excuse the taxpayer from requirements otherwise imposed (Payne 2003, p. 87). While the first category of provisions can be expected to have some impact on the burden of tax compliance, it is the second category that is expected to have the more significant impact on the compliance costs

of small businesses. Such relieving provisions include registration thresholds,<sup>7</sup> simplified accounting rules<sup>8</sup> and time related concessions.<sup>9</sup>

The rationale for enacting special small business tax regimes has been challenged in the literature (Freedman 2009, p. 18), mainly on the ground that these regimes may not meet their goal of correcting a market failure and achieving economic efficiency. Slemrod (2004, p. 69) also contends that special tax treatment may not be warranted as greater non-compliance and tax evasion in the small business sector compared to employees could actually offset their regressive compliance burden (Ahmed and Braithwaite, 2005; Kamleitner et al. 2012; Rawlings 2012). More importantly, attempts to reduce compliance costs may result in the creation of additional complexities. This is not only because of the proliferation of thresholds, but also because of the introduction of anti-avoidance or integrity provisions which often accompany concessional regimes (Freedman 2006, p. 59). Moreover, an adverse consequence of the introduction of ‘simplification’ schemes could be the increased need for small businesses to get professional advice before using the reliefs (Freedman 2009, p. 22).

This article collates and compares the outcomes of empirical research into the tax compliance costs of the small business sector which was conducted in 2010 and 2011 in Australia (Lignier and Evans 2012), Canada (Ebrahimi and Vaillancourt 2011), South Africa (Smulders, Stiglingh, Franzsen and Fletcher 2012) and the UK (Hansford and Hasseldine 2012). The study, exploratory in nature, was motivated by the recognition by researchers in each of the countries involved<sup>10</sup> that very little evidence of a truly comparative nature had yet emerged in the extensive compliance costs literature. Although, as that literature attests, tax compliance costs have been measured extensively in different countries, different methodologies have been used and therefore comparisons have been difficult and have had to be treated with caution. As noted by Chittenden, Kauser and Poutziouris (2003, p. 108), “[t]he extent to which

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<sup>7</sup> For instance, in the year ended 30 June 2011 (the relevant period for this study), the Goods and Services Tax (GST) A\$75,000 (US\$76,196) annual turnover threshold in Australia; the South African Value Added Tax (VAT) registration threshold of R1 million (US\$141,377); and the United Kingdom (UK) VAT registration threshold (as at 30 June 2011) of £73,000 (US\$116,057). Note, by way of contrast, that in Canada the relatively low GST registration threshold of C\$30,000 (US\$29,970) (which has not been increased since 1991) may not provide anything like the same level of relief as in the other three countries.

Also note that the currency amounts in this article are, where relevant for comparative purposes, translated into a US dollar value at the average conversion rates for the year from 1 July 2010 to 30 June 2011. The conversion rates were obtained from the Australian Taxation Office website, accessed in July 2012, at <http://www.ato.gov.au/taxprofessionals/content.aspx?doc=/content/00284996.htm>.

<sup>8</sup> For example, cash accounting regimes for GST in Australia; the “Quick Method” for GST in Canada; the use of a payments basis for VAT by certain sole proprietors in South Africa; and cash accounting for VAT in the UK.

<sup>9</sup> For example, those related to the timing of submission of GST/VAT returns in Australia, Canada, South Africa and the UK.

<sup>10</sup> At the outset of the project, Ireland and New Zealand were also involved. Funding for the Irish study failed to materialise with the result that Ireland withdrew from the project in early 2011. The involvement of the New Zealand researchers was disrupted by the Christchurch earthquake in February 2011. The New Zealand researchers were subsequently able to undertake a survey in late 2012/early 2013, in relation to the 2012 fiscal year. Given that the results of the New Zealand research relate to a later fiscal year than the research reported for the four countries in the broader project, it was decided that it would be inappropriate to include the New Zealand findings in this article. The findings are, however, separately reported in Gupta and Sawyer (2014).

it is possible to compare research methodologies and results....by business size and country is limited because of the lack of consistency in the empirical data”.

Conceptual and methodological issues were considered prior to the implementation of the research strategy and these are set out in Section 2 of the article. A standard research methodology was adopted across the four countries and a broadly common survey instrument was used in order to establish small business tax compliance costs and associated benefits, including an evaluation of the effectiveness of regimes designed to ‘simplify’ tax compliance obligations or counteract the regressive nature of compliance costs for small businesses. It was considered that this approach would address previously expressed concerns about international comparative studies and so “enlighten rather than mislead” (Sandford 1995b, pp. 405-406). The following sections, entitled ‘Composition of tax compliance costs’ (Section 3), ‘Managerial benefits’ (Section 4) and ‘Small business tax concessions’ (Section 5) consider the principal outcomes of the research project and the final section of the article provides the conclusions of the project.

The results from the four countries are remarkably consistent, despite some local differences and in spite of some limitations in the quality of the data collected. But although the results are consistent, they are also not particularly encouraging. They suggest that the burden of tax compliance costs continues to be large for the small business sector, in both absolute and relative terms. More depressingly, it appears to be the case that the problem is not getting any better, and that there has not been much success, thus far, in getting the settings right so far as tax policy for the small business sector is concerned.

## **2. CONCEPTUAL AND METHODOLOGICAL ISSUES**

This section outlines several conceptual and methodological issues that arose in relation to this study. These included: how a small business was to be defined; how the sample population was to be determined; the taxes that were to be covered; the identification and measurement approach of costs and benefits that was to be adopted; and a variety of other methodological issues.

### **2.1 Definition of small businesses**

There is no universally accepted definition of small business. Moreover, the definition of a small business for the purpose of tax concessions may vary even within the same jurisdiction between taxes. Hence it was decided to adopt a flexible, country specific, approach to how a small business was to be determined.

One criterion commonly used in all four countries is the number of employees. For the purposes of this study the maximum number of employees for a business to be defined as ‘small’ was taken to be 50, although in Canada the actual number varied between provinces. Responses from businesses with more than 50 employees were generally excluded from detailed analysis in the study.

Another criterion that was used in this study was turnover. Given the extensive use of different turnover thresholds in each of the four countries, it was decided to build in to the conduct of the research significant minimum and maximum turnover thresholds

employed in each of the countries for tax purposes. By using compulsory GST/VAT registration thresholds in each country we excluded tiny ‘hobby’ firms. As of June 2010, for GST/VAT purposes, minimum threshold turnover levels requiring compulsory registration were, in local currency (with equivalent US\$ in brackets): Australia A\$75,000 (US\$76,196); Canada C\$30,000 (US\$29,970); South Africa R1,000,000 (US\$141,377); and UK £70,000 (US\$111,288). Canada thus has the lowest threshold, with South Africa the highest. In addition, South Africa introduced a ‘micro’ business regime in 2009 designed to reduce administrative burden for businesses with a turnover up to the VAT threshold.<sup>11</sup>

A maximum annual turnover in local currency (and US\$) for a business to be classified as ‘small’, taking into account the relevant type of entity and applicable legislation, was also adopted in the research. For Australia this was the small business eligible entity limit of A\$2,000,000 (US\$2,031,901); for Canada it was the quarterly filing regime threshold of C\$6,000,000 (US\$5,994,006); for South Africa it was the small business corporation limit of R14,000,000 (US\$1,979,274); and for the UK it was the cash accounting scheme threshold of £1,350,000 (US\$2,146,264).

These criteria are summarised in Table 1, expressed solely in US\$.

**Table 1. Summary of criteria used for small business definition and classification: All countries (expressed in US\$)**

	Australia	Canada	South Africa	UK
<b>No. of employees</b>	50 or less	50 or less	50 or less	50 or less
<b>US\$</b>				
<b>Max. turnover</b>	2,031,901	5,994,006	1,979,274	2,146,264
<b>Min. turnover</b>	76,196	29,970	141,377	111,288

## 2.2 Determination of the sample population

Having determined that the sample populations of interest to the project were firms that had no more than 50 employees and having also determined that the survey instruments would be tailored to meet respective turnover thresholds relevant to small businesses within each country, it had then to be established which types of business (by reference to industry sector and by reference to the form in which the business was conducted) should be examined.

Given the breadth of small business activity across all industry sectors, it was determined that all sectors would be in scope for the study. Previous research (for example, Sandford et al. 1989; Evans, Ritchie, Tran-Nam and Walpole 1996; Chittenden, Kauser and Poutziouris 2005) suggests that compliance costs are not significantly affected by the industry sector in which the small business is operating. As a result, no attempts were made to ensure that all industry sectors were proportionately represented.

<sup>11</sup> A summary of the major tax concessions available to small businesses in each of the four countries in the period of the study is contained in Appendix A.



All appropriate forms of entity used to conduct business activities were considered in each of the four countries. It was expected that the corporate form of business would be the norm in all countries, together with partnerships and sole proprietorships. In Australia trusts were also included, as these are widely used by small businesses. Limited Liability Partnerships (LLPs) were also surveyed in Canada and the UK.

Hence the studies in the four countries endeavoured to cover a broad range of small businesses across all sectors of the economy, trading through all relevant types of business vehicle, although there were no formal attempts to ensure a stratified and representative sample. Moreover, no checks were ultimately made for non-response bias once completed surveys were received in three of the four countries.<sup>12</sup>

### 2.3 Tax coverage

The study measured the compliance costs associated with tax obligations, principally at the national level, to which small businesses are routinely exposed, as shown in Table 2. This covered GST/VAT obligations, personal income tax for self-employed individuals and partnerships, corporate tax for companies and payroll related taxes and levies.

**Table 2. Tax obligations of small businesses in each jurisdiction (2010–11)**

	<b>GST/VAT</b>	<b>Income Tax</b>	<b>Payroll related taxes</b>
<b>Australia</b>	GST (Federal) Rate: 10% (or GST free or input taxed) Quarterly reporting (instalment regime available)	Sole traders, partnerships & trusts: Progressive rates 15% to 45% Quarterly instalments if tax > A\$8,000 Companies: Rate : 30% Quarterly instalments if tax > A\$8,000)	PAYG withholding: Reported quarterly or monthly if liability > A\$25,000 p.a.
<b>Canada</b>	GST (Federal) : Rate 5% Quarterly reporting  PST (provincial)*: Average rate 7% (no PST in some provinces) Reporting : varies	Sole traders, partnerships, LLPs: Federal: progressive rates 15% to 29% Province: progressive varies (collected federally) Quarterly instalments Companies: Federal: 11% (on the first C\$400,000) Province: progressive rates (collected federally)† Quarterly instalments where tax > C\$3,000	Federal: Income tax Pension plan Employment Insurance Reported quarterly (monthly if remittance > C\$3,000) Provincial: Various payroll tax and contributions e.g. health premium in Ontario,

<sup>12</sup> A 'wave analysis' was conducted in South Africa, which concluded that there was no evident response bias (Smulders et al., 2012). Non-response bias has not generally been identified as a significant issue in previous compliance costs research, although some studies have undertaken extensive testing to establish the extent, if any, to which it exists (e.g. Evans et al., 1996).

<b>South Africa</b>	VAT Rate: 14% (or zero rated or exempt) Reporting every two months (quarterly reporting if taxable supplies do not exceed R1.5m)	Sole traders, partnerships: Progressive rates 18% to 40% Bi-annual instalments Companies: Rate : 28% Bi-annual instalments	PAYE: Reported monthly
<b>UK</b>	VAT Rate 17.5% (or zero rated or exempt) to 4 January 2011; 20% (or zero rated or exempt) from 4 January 2011. Quarterly reporting (Flat rate scheme if turnover under £150,000)	Sole traders, partnerships, LLPs: 40% above £36,600 2 payments (account) Companies: (Rates change on 1 April with those for period 1 April 2011 to 30 June 2011 given in brackets) Rate on profits £0–£300,000: 21% (20%) £300,001–£1,500,000: 21-28% (20–26%) Over £1,500,000: 28% (26%) Single annual payment	PAYE & NIC: Reported quarterly, (monthly if liability > £1,500 p.m.)

\* Three provinces (New Brunswick, Nova Scotia and Newfoundland) have combined the Provincial Sales Tax (PST) and the GST into a single tax called Harmonized Sales Tax (HST); British Columbia and Ontario moved to HST in July 2010 but British Columbia subsequently withdrew from the arrangement (in August 2011). Alberta, The Northwest Territory, Yukon and Nunavut do not impose any PST.

† Two provinces (Quebec and Alberta) collected the provincial company tax directly.

## 2.4 Identifying and measuring tax compliance costs

The term ‘tax compliance costs’ used in this study follows and builds on the work undertaken in previous studies (Sandford et al. 1989; Evans et al. 1996). Inevitably different methodologies have been used by different authors when measuring tax compliance costs (Sandford 1995a; Evans 2003). While there is some controversy as to which method provides the most accurate measure (Turner, Smith and Gurd 1998), two components of tax compliance costs are generally identified as being critical to the measurement of tax compliance costs: internal costs and external costs.

For the purposes of the surveys in each of the countries, internal compliance costs were distinguished from external compliance costs, even though there is no categorical listing of what elements of compliance costs are deemed ‘internal’ and which ‘external’. For small companies the work outsourced to external advisers may be more basic than for larger companies. The very nature of small businesses are such that they are all very different with differing needs requiring different levels of support at various stages in their development. An example of this is, of course, payroll costs. A large organisation with hundreds of employees will usually deal with all payroll costs in-house, as that is the cheapest and most efficient way to handle them. The number, and potentially the complexity, of the payroll functions in a large organisation will be such that investment in full time employees to manage the payroll will be justified. For small businesses the payroll function may be cheaper to operate through an external payroll bureau as the time required to keep up-to-date and maintain the accuracy of the payroll function may not be justified. Previous studies (Sandford et al.

1989, p. 95; Godwin 2001, p. 12) have shown that the payroll costs per employee are highly regressive and, in practice, small organisations tend not to have the time or expertise to administer the (often complex) system effectively. This example shows that payroll costs will be an ‘external’ compliance cost for many small businesses, whereas for larger businesses they will often be an ‘internal’ compliance cost.

The above goes some way to explain the complexity of identifying different types of compliance costs for a range of types of small businesses across international boundaries. The four-country study undertaken in Australia, Canada, South Africa and the UK encountered several operational issues in exactly defining internal and external compliance costs and within these categories the different time scales and costings for each event. For the analysis that follows the distinctions for internal compliance costs are those incurred within the limitations of the firm and external costs are those outsourced and paid for from commercial organisations set up to provide those services. The dividing line for ‘pro bono’ work carried out by friends and relatives gives added complexity to dividing costs for small firms, as in practice small businesses do need to ‘call in’ favours from those actively interested in the small organisation, although not directly employed by the small business.

Typically, then, internal costs are the costs of labour/time consumed in completion of tax activities. For example, the time taken by a business person to acquire appropriate knowledge to deal with tax obligations such as Pay As You Earn (PAYE) or GST/VAT; or the time taken in compiling receipts and recording data in order to be able to complete a tax return. Tax related activities can include such activities as: recording information; dealing with the tax authorities; dealing with tax advisers; learning about tax laws; and tax planning activities (Colmar Brunton 2005).

External costs are the costs of expertise purchased to assist with completion of tax activities (typically, the fees paid to professional tax advisers). Such external service providers may be used simply to undertake tax compliance activities, for example, the preparation and submission of returns and reports; alternatively they may provide tax planning services. The former is usually accepted as being an activity that has to be undertaken, while tax planning or mitigation is often seen as a voluntary or discretionary service. But typically the literature makes no distinction between the two, accepting that practically the costs are indivisible and that both are components of the external costs of tax compliance (Evans 2008, p. 452).

The assessment of tax compliance costs requires the identification and estimation of such internal and external costs incurred while carrying on various tax related activities. Together these costs comprise the *gross* costs of tax compliance. These ‘gross’ costs of compliance incurred by business taxpayers may be partly offset by tax compliance benefits (Sandford et al. 1989, pp. 13-14; Tran-Nam, Evans, Walpole and Ritchie 2000, pp. 237-238), which include cash flow benefits, tax deductibility benefits and managerial benefits. While the first two types of benefits have been incorporated in previous studies (Allers 1994; Evans et al. 1996), managerial benefits have generally been ignored. Managerial benefits are derived by the taxpayers, in particular small business taxpayers, where the more stringent record keeping requirements imposed by tax compliance result in the production of managerial accounting information available for decision making and other business purposes (Sandford et al. 1989, p. 89; Lignier 2006, p. 416).

It was decided that this study would primarily focus on managerial benefits rather than on the two other types of tax compliance benefits for three reasons. First, cash flow benefits to small firms are likely to be close to zero (given the levels of withheld tax involved and exceptionally low interest rates at present). Second, current rules for deducting tax compliance costs in tax returns are unlikely to be changed. Third, and most importantly, small firms tend to lack specialist skills in the area of employment law, financial management and tax, which, coupled with competing demands on owner-managers' time, means that studying managerial benefits accruing from the tax system is especially relevant and a contribution to the existing literature.

## 2.5 Survey administration

The method of administration chosen for this study was an 'electronic survey', where potential respondents were contacted by email and referred to a survey web page. The main advantage offered by electronic surveys is that they are a much quicker and much cheaper way to access a large sample over a wide geographical area (Kaplowitz, Hadlock and Levine 2004, p. 94). As such this methodology is particularly well adapted to international research targeting widely dispersed populations of potential respondents.

The other significant advantages of using the internet to administer the survey include cost savings associated with eliminating the printing and mailing of the survey instrument as well as time and cost savings of receiving the survey data in electronic format (Kaplowitz et al. 2004). The main disadvantage is that internet coverage is not universal and that in populations with access to the internet, the response rate is lower than with other survey methods (Kaplowitz et al. 2004). Another possible problem associated with internet survey is the possibility that emails may be treated as junk email or spam by potential respondents (Kaplowitz et al. 2004, p. 95).

Data were collected using separate questionnaires for each country, which did however follow a common structure. So while the questionnaires were adapted for different types of taxes and terminology, e.g. GST or VAT, the questionnaires did ask respondents for identical measures (e.g. number of hours spent on particular compliance activities) that allowed for the comparative analyses made later in this article. The 'original' common questionnaire was drafted by the authors of this article based on prior research. It was widely exposed to other academics, practitioners and revenue agencies (Her Majesty's Revenue and Customs, the South African Revenue Service (SARS)) and input was received from the World Bank. A pilot exercise was also conducted in Australia and South Africa.

In terms of the 'harmonised' questionnaire, one important exception was made in respect of the UK. At the time the questionnaires were being developed and administered in 2010/2011, the UK Government had instituted a review of tax reliefs and allowances, under the auspices of the newly-formed Office of Tax Simplification (OTS). Given that it was unknown exactly what the OTS would recommend, or how

the UK Government would respond, a decision was made to remove the section on small business tax concessions (SBTCs) from the UK questionnaire.<sup>13</sup>

In terms of sample population, South Africa was the only country where co-operation from the revenue agency (SARS) allowed an entire population of small businesses to be surveyed. In the other three countries either a commercial database was used (Australia and Canada) or a partner was sought to send out the email invitations (UK).

Set out below are pertinent details in relation to each country:

- Australia: an email invitation (with one email reminder and partial telephone follow up) was sent to 3,500 small businesses on a commercial database. The email contained a link to LimeSurvey, an open source survey application and the yield was 159 usable responses (4.5% response rate).
- Canada: a bilingual (English and French) survey was used. Email invitations were sent to 2,449 firms across Canada, followed by two email reminders and 250 phone calls. Of 55 questionnaires ultimately received, only 33 of them contained enough information to be able to be used in the survey (1.35% response rate). Moreover, five questionnaires were eliminated as they had more than 50 employees; also, three more firms were excluded as a result of inaccurate and contradictory information provided by the respondents. This left only 25 usable responses.
- South Africa: email invitations were sent to 88,057 small businesses with 5,865 usable responses (6.7% response rate).
- UK: emails were sent to 4,420 accountants working in a small business with a link to an open source survey application, with 40 usable responses. One of the chief differences between the UK and the other three countries was that instead of going direct to small businesses, because the researchers were able to negotiate assistance direct from the Association of Chartered Certified Accountants (ACCA), a decision was made to use their database for the email invitations. However, in the end, the response rate was a disappointing 0.9%.

Overall, therefore, there was a very low and somewhat disappointing response rate in two of the countries (Canada: 1.35%; and the UK: 0.9%). In Australia the response rate of 4.5%, whilst higher, was still not as good as was anticipated. The response rate in South Africa was the most impressive at 6.7%, reflecting direct revenue authority (SARS) assistance and a very large potential population of respondents. For the other countries, without revenue authority support, a sizeable research grant and more extensive use of research assistants, it was not possible to put additional resources into contacting respondents directly and encouraging greater participation.

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<sup>13</sup> The OTS identified 1,042 reliefs, and looked at 155 in detail, recommending in their final report of March 2011 that 54 remain unchanged, 37 be looked at in yet more detail, and 47 be abolished on the basis that they were either time expired, there was no ongoing policy rationale, the value was negligible, or the benefit was outweighed by the administrative burden (Office of Tax Simplification 2011). Interestingly, the OTS decided to not review VAT reliefs, prompted by a Green Paper announcing a review of VAT published by the European Commission at about the same time (European Commission 2010).

### 3. COMPOSITION OF TAX COMPLIANCE COSTS

The general trends across the internationally collected data are interesting to consider and the following sections identify the more significant of these trends.

#### 3.1 Internal tax compliance costs

The questionnaires in each of the four countries asked respondents to assess how much time they spent dealing with particular types or categories of tax. Their responses, with values translated to US\$, are summarised in Table 3.

**Table 3. Allocation of internal compliance costs to each tax (expressed in US\$)**

	<b>Australia (US\$)</b>	<b>Canada (US\$)</b>	<b>South Africa (US\$)</b>	<b>UK (US\$)</b>
<b>GST/VAT</b>	12,141 58.2%	6,600 16.2%	2,872 38.0%	9,638 41.3%
<b>Income Tax</b>	4,570 21.8%	24,333 59.6%	2,237 29.7%	6,935 29.7%
<b>PAYG/PAYE</b>	3,183 15.3%	7,280 17.8%	2,337 31.0%	5,795 24.9%
<b>CGT</b>	236 1.1%	N/A	76 1.0%	957 4.1%
<b>Other *</b>	749 3.6%	2,620 6.4%	20 0.3%	N/A
<b>All taxes</b>	20,879 100%	40,833 100%	7,542 100%	23,325 100%

\* comprises FBT in Australia, QST/PST in Canada, and Customs & Excise in South Africa

The broad indication given by these results confirms the outcomes given in previous studies. For three of the four countries, VAT/GST takes up by far the largest share of the internal costs of tax compliance: 58.2% in Australia; 38% in South Africa; and 41.3% in the UK. The ratios of the other principal taxes or taxing mechanisms in relation to VAT/GST compliance costs are broadly in line. Canada stands out from the others with relatively high levels of income tax internal compliance costs. The low level of responses for that country suggests the figures for Canada should be viewed as indicative only.

Respondents were also asked to report internal time spent on specific tax activities. The different options were taken from the list adopted in a survey of New Zealand small businesses (Colmar Brunton 2005) which had been developed from the taxonomy of tax activities used by Evans et al. (1996). As shown in Table 4, the main categories of tax-related tasks offered to respondents were: recording information needed for tax; calculating tax; completing tax returns and paying taxes; dealing with the tax office; tax planning and tax advice; dealing with the tax adviser; and learning about tax law.

Table 4 has taken the actual responses for each country and established the percentage of time for each task in order to enable outline comparisons to be made. The

responses from the four studies were broadly in line, with recording information by far the most significant item, accounting for more time than most other activities put together. The UK and Australian respondents spent two thirds of their time on this activity, whilst in Canada and South Africa small business respondents spent roughly half of their internal tax compliance time on this record keeping function.

**Table 4. Percentage of time spent on various internal compliance tasks for all taxes**

	Australia %	Canada %	South Africa %	UK %
Recording information needed for tax	66	45	52	66
Calculating tax, completing tax returns and paying taxes	15	21	17	11
Dealing with the tax office	1	5	9	4
Tax planning and advice	4	6	5	4
Dealing with external advisers	8	10	8	7
Learning about tax	5	12	9	8
Other activities	1	1	0	0
Total	100	100	100	100

Following the methodology adopted in Evans et al. (1996, p. 15), a separate question invited survey respondents to report annual hours spent on specific core accounting activities. This question was designed to alert respondents to the fact that there are business accounting functions which are not related to taxation – thereby hopefully enabling them to more precisely disentangle tax compliance costs from other costs of compliance. These core accounting functions therefore included tasks that are an integral part of the business operations: processing customer invoices and payments; monitoring customer payments; paying bills; calculating and paying wages; checking bank balances and monitoring trading stocks. Two activities were added for this survey: investment planning unrelated to tax; and budgeting and control.

The outcomes from the surveys in each of the four countries are reported in Table 5, where again the actual responses for each country have been converted into percentages of time taken for each task, in order to enable international comparisons to be made.

**Table 5. Percentage of time spent on various internal non tax-related compliance activities**

	Australia %	Canada %	South Africa %	UK %
Processing invoices/cash	47	31	44	24
Following up debtors	8	4	12	10
Paying bills	12	28	11	10
Calculating/paying wages	14	10	7	5
Cash/bank reconciliation	6	8	13	4
Stocktaking/stock control	4	2	5	10
Non-tax investment planning	0	2	2	7
Budgeting and control	0	4	6	12
Other activities	9	11	0	18
Total	100	100	100	100

It is interesting to note that, across the four countries studied, the responses for this question did not follow a similar pattern. This possibly suggests that the range of other non-tax activities required in the four countries, and the level of involvement in these activities, ranges more widely throughout the various respondent groups. This aspect is considered further in the following section of this article (Managerial benefits), where the disentanglement of tax and accounting costs, together with the potential benefits of tax compliance, are explored.

### 3.2 External tax compliance costs

Each country study required respondents to identify the amount they spent on the external provision of services required in order to comply with their obligations under the various regulations within the four countries studied. These were split into external costs relating to tax services, non-tax services and payroll services. All respondents identified some costs in each category and Table 6 provides full details. In order to provide comparisons between the results from the four studies the local currencies were converted to US dollars based on the average exchange rates for the year ended 30 June 2011 in Table 6.

The results suggest that external compliance costs are high in absolute terms for small businesses in all four countries, and that the tax element of such costs is a significant burden. South African small businesses experience the lowest average external compliance costs, whilst the UK's figures appear particularly high, mainly as a result of relatively high non-tax related external compliance costs.



**Table 6. External compliance costs (expressed in US\$)**

	<b>Australia (US\$)</b>	<b>Canada (US\$)</b>	<b>South Africa (US\$)</b>	<b>UK (US\$)</b>
Tax related	12,458	6,006	3,445	8,719
Payroll	1,303	3,447	1,310	4,456
Total external tax compliance costs	13,761	9,453	4,755	13,175
Non-tax related	4,633	6,779	3,999	19,081
Total external compliance costs	18,394	16,232	8,754	32,256

### 3.3 Total tax compliance costs

Table 7 combines the internal and external tax compliance costs as reported in the four countries, again converted to a standard currency (US\$). The results (ranging from mean tax compliance costs of US\$12,2970 in South Africa to US\$50,286 in Canada), suggest that tax compliance costs are a significant cost to small businesses in all four countries. The lower absolute costs in South Africa are not surprising, given the developmental nature of the economy and the significant number of micro-enterprises. The higher absolute costs in Canada appear at first blush to be more surprising, particularly when compared to Australia and the UK which have total tax compliance costs only 60 or 70 per cent as high as Canada. It is possible, however, that the low number of responses in Canada may have given rise to anomalous results for that country, and no great significance is attached to the figure that emerges.

**Table 7. Total tax compliance costs**

	<b>Australia (US\$)</b>	<b>Canada (US\$)</b>	<b>South Africa (US\$)</b>	<b>UK (US\$)</b>
<b>Internal tax compliance costs</b>	20,879	40,833	7,542	23,325
<b>External tax compliance costs</b>	13,761	9,453	4,755	13,175
<b>Total tax compliance costs</b>	34,640	50,286	12,297	36,500

In line with previous research (e.g. Evans et al. 1996), internal costs are generally much higher than external costs and comprise between 61% (South Africa) and 81% (Canada) of total tax compliance costs. Internal tax compliance costs in Australia and the UK are respectively 68% and 64% of total tax compliance costs.

Given the relative clustering of Australia, South Africa and the UK (where internal tax compliance costs are in the range of 61% to 68% of total tax compliance costs), one interesting question might be why Canadian tax compliance costs (where 81% of total tax compliance costs are constituted by internal compliance costs) is out of line. Again, it is difficult to provide any meaningful answer to this question given the low

response rate in the Canadian survey (though the non-generalizability of the data as a result of the low number of responses may, in fact, partially answer the question).

The four studies all find regressive compliance costs with size, with relatively smaller businesses bearing disproportionately higher costs of compliance. Traditional patterns of regressivity, and the economies of scale that arise as business size increases, were very evident in all four countries (Lignier and Evans 2012; Ebrahimi and Vaillancourt 2011; Smulders et al. 2012; Hansford and Hasseldine 2012).

## **4. MANAGERIAL BENEFITS**

### **4.1 Identification and evaluation of managerial benefits and the tax/accounting overlap**

Benefits of tax compliance including ‘managerial’ benefits were first identified in the 1980s by Sandford et al. (1981). It was argued that compliance with the tax system would force business owners to introduce more efficient financial information systems (Sandford et al. 1989, p. 13), which would in turn result in improved decision making (a managerial benefit) particularly for small businesses (Tran-Nam 2001, p. 55).

While the concept is somewhat intuitive, the identification and evaluation of managerial benefits may be problematic. The identification problem is largely linked to an accounting/tax overlap: many accounting and record keeping functions within the businesses are performed for the joint purpose of preparing managerial information and meeting tax compliance requirements (Tran-Nam 2001, p. 55). The so-called disentanglement dilemma of how to allocate common costs between the two functions has been amply discussed in the literature, including in work by Johnston (1963), Allers (1994) and Sandford (1995a). Sandford advocated the use of an incidental approach to resolve this problem: the costs of core accounting functions, that would have been incurred regardless of taxation, should be excluded from tax compliance costs; on the other hand, any incremental costs of the accounting function generated by tax compliance should be included (Sandford 1995a, p. 396).

The other dimension of the overlap problem relates to the perception that taxpayers have of compliance costs. At one extreme, taxpayers may regard all the costs involved in keeping records and preparing accounts as tax compliance costs because taxation is the only reason they recognise for performing these activities. In this situation, any use of the information for a purpose other than tax compliance should be regarded as an offset to compliance costs in the form of a managerial benefit. At the other extreme, tax record keeping may be described as no more than a by-product of an ordinary accounting function (Tran-Nam 2001, p. 57).

The evaluation of managerial benefits is even more contentious than their identification. Sandford, Godwin, Hardwick and Butterworth (1981, p. 91) proposed to measure these benefits on the basis of a subjective value assigned by taxpayers. However, Lignier (2009a, p. 117) argued that subjective valuations should be calibrated against a benchmark, and proposed to assess managerial benefits on the basis of the perceived value of the accounting information actually used by taxpayers in their managerial decisions. A proxy of that value could be derived by asking taxpayers how much they would pay for accounting information about their business

in the hypothetical situation where no tax compliance obligations were imposed on the business.

To date, specific studies on managerial benefits have only been undertaken in the UK and in Australia, and in the case of the UK the National Audit Office (1994, p. 20) study focused on VAT only. It appeared therefore that a comparative research project involving different countries would broaden and strengthen the existing knowledge on the topic. The current study had two broad aims in this respect.

First, in an attempt to analyse the tax/accounting overlap, it sought to investigate the main reasons for keeping accounting records and to identify separately costs relating to core accounting activities and tax record keeping costs. Second, it aimed to collect and analyse data about managerial benefit perception among small business taxpayers. Apart from the collection of further empirical evidence on managerial benefits, the researchers' intent was to find out whether different legislative and compliance regimes had a significant impact on such managerial benefits.

The findings about the tax/accounting overlap are first discussed, then managerial benefit perception by taxpayers. The section concludes with some general remarks about the significance of managerial benefits in small businesses and the need for further research in this area.

## **4.2 Analysis and comparison of the tax/accounting overlap**

An important source of managerial benefits comes from the necessity for small business taxpayers to have a complete record keeping system where all the business transactions are carefully recorded. This necessity is further reinforced with the introduction of transaction based taxes such as GST and VAT that compel the taxpayer to have an accurate and up-to-date record of transactions throughout the financial year (Lignier 2009a, p. 120). For most small businesses, this will translate into setting up an accounting system (generally computerised) with the dual purpose of fulfilling tax-imposed record keeping obligations and performing core accounting functions.

Although, the tax/accounting overlap cannot be directly assessed with objective measures, a number of qualitative and quantitative indicators can help to disentangle the two functions. Based on prior research by Tran-Nam (2001) and Lignier (2008), the qualitative indicators selected for this project were the predominant reason for keeping records and the uses of financial information, and the quantitative indicators were the reported number of hours spent on core accounting activities and tax record keeping. Data relating to these qualitative and quantitative indicators are summarised in Table 8.

**Table 8. Tax compliance/accounting indicators: Inter-country comparison**

	Australia	Canada	South Africa	UK
<b>Reason for keeping records:</b>				
-Mainly accounting:	42%	30%	43%	67%
-Mainly or only tax:	17%	35%	25%	10%
-Equally for both:	39%	35%	31%	23%
<b>Use of financial information:</b>				
-Tax use only:	6%	9%	4%	0%
-Internal management:	83%	70%	83%	85%
-External reporting:	55%	61%	72%	68%
<b>Annual time spent on core accounting activities (mean)</b>	1,766 hours	1,786 hours	1,117 hours	3,527 hours
<b>Annual time spent on record keeping for tax (mean)</b>	323 hours	217 hours	132 hours	289 hours

The dual purpose of the record keeping system is reflected in the tax/accounting overlap indicators reported in the surveys for the four countries (Table 8). While there seem to be a variety of opinions as to the *predominant* reason for keeping records, less than 10 per cent of taxpayers in each of the four jurisdictions indicated that they were using the information for tax purposes only. On the other hand, a vast majority of small business taxpayers (between 70 and 85 per cent) used accounting information for internal management and a significant majority used it for external reporting.

Self-reported internal time data suggest that small businesses in all four countries spent far more time on core accounting functions<sup>14</sup> than on record keeping for tax compliance purposes. The ratio between the number of hours spent on accounting and the number of hours spent on tax record keeping varies significantly across the four countries, but is always high (ranging from 5:1 in Australia; through 8:1 in Canada and South Africa; to 12:1 in the UK). This would suggest that tax compliance record keeping activities were seen as incidental to the main accounting function rather than the production of accounting information being a by-product of tax compliance.

Although the questionnaire clearly emphasised the distinction between ‘core accounting activities’ and tax record keeping, it is possible that some double counting occurred as it is not always obvious where the line between the two functions is drawn in practice. For example, recording sales transactions would normally be seen as part of processing customer invoices (a core accounting function), but it may also be seen by some business taxpayers as a tax compliance activity to work out the amount of GST/VAT collected on sales.

Another question is whether businesses would have spent *as much* time on core accounting activities if there were no tax compliance obligations. Lignier (2008, p.

<sup>14</sup> The core accounting functions included: processing customer invoices and cash payments; following up debtors; paying bills; calculating and paying wages; checking bank records; stock control; investment planning; and budgeting and control.

362) investigated this issue and found that the presence of tax obligations had a significant effect on the sophistication of the accounting system and on the frequency and variety of accounting reports prepared.<sup>15</sup> It follows from this outcome that even where accounting time and tax compliance time can be identified separately, the disentanglement is not complete insomuch as the number of hours spent performing core accounting functions may be dependent on the requirement to prepare tax reports. In other words, taxpayers may be spending more hours during the year performing the same accounting tasks than they would normally have, only because the same records are also used for tax purposes.

### 4.3 Managerial benefit perception

Perception is an important dimension of the concept of managerial benefit. The reality of managerial benefits can be elusive as it is dependent on how the accounting information generated by tax compliance activities is valued by business owner-managers and used in business decisions. Hence, the actual realisation of managerial benefits by the firm will be closely related to the perception that owner-managers have about the usefulness of the information generated by record keeping activities (Lignier 2009b, p. 394).

Perception about managerial benefits can be analysed at different levels. Firstly, the idea that benefits might be derived from tax compliance, an activity first and foremost assumed to generate costs, may not always be obvious to taxpayers. Sandford et al. (1981, p. 94), for example, found that 40 per cent of small business taxpayers in the UK saw no benefit in complying with VAT. In contrast, a high proportion of respondents in the current study agreed that tax compliance had some benefits for their business with the exception of Canada (Table 9). A variety of benefits were perceived by small business taxpayers, but a managerial benefit in the form of a better knowledge of financial affairs was the most commonly identified. The proportion of respondents who believed their business derived a managerial benefit was generally above 50 per cent with the exception of Canada. This result confirms earlier findings in Australia (Evans et al. 1996, p. 132; CPA Australia 2003, p. 17), New Zealand (Sandford and Hasseldine 1992, pp. 96–97) and the UK (National Audit Office 1994, p. 20).

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<sup>15</sup> Lignier's study compared accounting activities in small businesses in mainland Australia with businesses resident in Norfolk Island, a jurisdiction that was virtually tax-free at the time of the survey.

**Table 9. Managerial benefit perception: comparison between countries**

	<b>Australia</b>	<b>Canada</b>	<b>South Africa</b>	<b>UK</b>
Overall benefits of tax compliance	Very High	Low	Very High	High
Managerial benefits of tax compliance (better knowledge of financial affairs)	Average-High	Low	High	Average-Low
Benefits of tax record keeping: improves quality and accuracy of records	High	Average	Very High	Average
Value in relationship with external accountant/tax adviser	Average-Low	Average-Low	Low	Average
Would still pay for external accounting services even if there was no tax compliance	47%	68%	39%	38%

A better knowledge of the firm's financial affairs is assumed to result from an improvement in the quality and the accuracy of financial records. Findings across the four jurisdictions confirm this assumption: high levels of managerial benefit perception were generally associated with a strong recognition that tax record keeping improved the quality of the records. However, not all small business taxpayers who saw an improvement in the record keeping perceived that they derived a managerial benefit for their business: for instance, 76 per cent of South African respondents agreed that their records were improved because of tax compliance but only 69 per cent said that it improved financial knowledge about their business (Smulders et al. 2012). A similar pattern can be observed in the three other jurisdictions. In other words, some business taxpayers did not believe that better record keeping translated into an actual benefit, possibly because they saw record keeping as fundamentally a tax compliance activity rather than the preparation of managerial information.

In terms of valuing the relationship with their external accountant/tax adviser, other than the UK, less than half of the respondents saw value in the relationship with their accountant. Notwithstanding this result, in each country over one-third of all respondents indicated they would still pay for external accounting services even if there was no tax compliance (Table 9).

## **5. SMALL BUSINESS TAX CONCESSIONS**

Many governments have made endeavours to reduce the tax compliance burden faced by small businesses by introducing various strategies and measures (tax concessions) to achieve a reduction in the tax compliance burden for small businesses (OECD 2008, p. 8; SARS 2011, pp. 30–32). The nature of such small business tax concessions (SBTCs), as mentioned earlier, can be divided into two broad categories: *positive concessions* that provide a lower rate of taxation, an exemption or an accelerated deduction; and *relieving concessions* that excuse the taxpayer from requirements

otherwise imposed (Payne 2003, p. 87). When comparing the nature of the SBTCs in each of the four countries,<sup>16</sup> it was apparent they all use a combination of positive and relieving SBTCs which, overall, are quite similar in nature.

In view of these similarities, it was believed that there would be value in researching the extent to which the SBTCs achieved their objective of reducing the tax compliance burden in the four countries under review. In order to achieve this, the take up (eligibility) and use of the SBTCs by small businesses in each country were initially considered. The small businesses' perceptions of the SBTCs' usefulness and level of complexity were subsequently considered. Unfortunately, for the reasons mentioned earlier, the UK survey did not incorporate the SBTC questions and cannot therefore be incorporated in the further analysis of the SBTCs. Notwithstanding this, comparison between the remaining three countries still provides sufficient meaningful information about the role of SBTCs.

**Table 10. Perceptions of eligibility for, and actual use of, SBTCs**

	<b>Australia</b>	<b>Canada</b>	<b>South Africa</b>
Thought they were eligible	14%	35%	12%
Thought they were not eligible	58%	39%	47%
Unsure	27%	26%	41%
Actual use of SBTCs by eligible entities	<b>80%</b>	<b>100%</b>	<b>68%</b>

Table 10 summarises the views of respondents about their eligibility and use of the SBTCs. Very few respondents in all three countries (between 12% and 35%) thought they were eligible to use SBTCs. Awareness of the SBTCs appears to be a problem, particularly in South Africa. However a large percentage of those eligible businesses actually used the SBTCs, indicating a good adoption of the SBTCs once the businesses became aware of their eligibility for them. Eligibility for, and to a lesser extent awareness of, the SBTCs are clearly perceived as stumbling blocks to the successful adoption and use of the SBTCs in all three countries.

To obtain further insight into the SBTCs, the respondents' perceptions of the usefulness/complexity<sup>17</sup> of each of the SBTCs in their specific country was investigated. It was found that in Australia, the simplified capital allowance regime was perceived to be the most useful of the SBTCs, whereas in Canada it was the less frequent tax payments concession and in South Africa it was the less frequent submission of VAT returns. From a complexity perspective, the Australian respondents perceived the simplified capital allowance regime to be the most complex (despite it being regarded as the most useful SBTC); the Canadians found it to be the GST measures and the South African's perceived it to be the Small Business Corporation tax regime. The respondents' attitudes from all three countries (but specifically Australia and South Africa) revealed a similar lack of knowledge and level of non-commitment to the usefulness/complexity of the SBTCs in each particular

<sup>16</sup> Refer to Appendix A for a summary of the main SBTCs in each country.

<sup>17</sup> Complexity not only increases the likelihood that taxpayers (specifically small businesses) will evade tax, but also increases tax compliance costs (Roth, Scholz and Witte 1989).

country. This in itself indicates that more research is needed into the awareness and effectiveness of these SBTCs.

To obtain a broad understanding of the effectiveness of the SBTCs, the external service provider's role in the SBTCs and their (the respondent's) general attitude towards the SBTCs, the respondents were requested to indicate their level of agreement or disagreement with five statements dealing with these issues. The findings to these attitudinal questions are presented in Table 11.

The high level of uncertainty (measured by reference to the 'Unsure/Not Applicable/Not Relevant' responses) displayed by the owner-managers of small businesses is striking, particularly so far as Australia and South Africa are concerned. (As noted earlier, far less reliance is placed upon the Canadian data given the low number of observations.)

**Table 11. Perceptions of SBTCs in general**

<b>SBTCs saved my business some tax dollars/rands</b>	<b>Australia %</b>	<b>Canada %</b>	<b>South Africa %</b>
Agree/Strongly Agree	13	48	15
Disagree/Strongly Disagree	18	26	13
Unsure/Not Applicable/Not Relevant	79	26	72
<b>SBTCs are so complex that it is hardly worth the effort</b>			
Agree/Strongly Agree	33	48	29
Disagree/Strongly Disagree	11	26	12
Unsure/Not Applicable/Not Relevant	66	26	59
<b>I was well advised by my accountant regarding the benefits of SBTCs for my business</b>			
Agree/Strongly Agree	27	65	25
Disagree/Strongly Disagree	12	4	15
Unsure/Not Applicable/Not Relevant	62	30	60
<b>Accountants have a self interest in pushing the use of SBTCs</b>			
Agree/Strongly Agree	8	26	8
Disagree/Strongly Disagree	23	26	22
Unsure/Not Applicable/Not Relevant	79	48	70
<b>SBTCs are a waste of time; would be better off with lower taxes and a simpler tax regime instead</b>			
Agree/Strongly Agree	41	44	41
Disagree/Strongly Disagree	6	17	10
Unsure/Not Applicable/Not Relevant	53	39	49



It is also noticeable that in all three countries SBTCs are perceived to be so complex that they are hardly worth the effort. The rate of agreement with this statement is double or treble the rate of disagreement. External service providers (specifically in Canada) play an important role in assisting small businesses with the SBTCs — perhaps because of their complexity. With the exception of those in Canada, small businesses appear to be unsure of the benefits offered by the SBTCs. For the most part, the perception of small businesses in all three countries is that the SBTCs are a waste of time and that they would be better off with a lower tax rate and a simpler tax system. A possible reason for this perception could be as a result of the fact that a large proportion of the respondents were not eligible for the SBTCs and found them to be complex.

Achieving similar results with regard to the eligibility, usefulness, complexity and effectiveness of SBTCs across three jurisdictions is an indication that perhaps more consideration should be given to them by policy makers across the globe. This attention is critical so as to ensure that the SBTCs conclusively achieve one of their major objectives — the reduction of the tax compliance burden faced by small businesses.

## 6. CONCLUSIONS

This comparative study had three broad objectives: to identify, measure and compare the compliance burden for the small business sector in the four countries; to establish the extent, if any, to which there were off-setting managerial benefits arising as a result of compliance with tax obligations; and to investigate whether various small business concessional regimes are achieving one of their stated objectives of relieving some of the effects of the compliance burden.

Unfortunately, difficulties with the administration of the survey in two of the four countries (Canada and the UK, largely as a result of funding and resource constraints), has meant that only general indicative comparisons can be made across all four countries and this is a limitation of this study. The higher level of responses in the other two countries (particularly in South Africa) does, however, provide some level of comfort in the findings from these countries.

The outcomes of the research, reasonably consistent across all four countries, confirm earlier research findings that compliance costs for the small business sector continue to be high in both absolute and relative terms. Even within the sector they are very regressive, and transactional taxes such as the GST/VAT continue to be the cause of the highest compliance costs. Tax compliance costs which are internal to the business are by far the biggest element of total tax compliance costs, usually comprising in excess of 60% of all costs. Within those internal costs of tax compliance, most business time was spent in recording information needed for tax, constituting in excess of half of the time spent by businesses in complying with tax obligations in Australia, South Africa and the UK, and very nearly half the time in Canada.

It was not possible to conduct inter-temporal comparisons across all four countries to establish whether the total tax compliance burden was increasing or diminishing over time. Studies from particular countries (for example, Lignier and Evans 2012 in

relation to Australia) do suggest, however, that the burden is not diminishing over time, again consistent with previous research.

By and large, small business taxpayers surveyed for this study perceived that they were deriving benefits from tax compliance activities in the form of better financial information that helps them to manage their businesses. The two main sources for these benefits seemed to be the enhanced quality and accuracy of record keeping and access to better knowledge of financial affairs. The generally consistent results suggest that the realisation of managerial benefits was not dependent on the specific nature of tax compliance obligations. However, even though managerial benefits were perceived by a majority of taxpayers in all four countries, their importance might vary. Further research is required in each country to attempt to measure the extent of these benefits.

There was less reliable data relating to the usefulness of the various concessional regimes introduced for small businesses in the four countries to mitigate the impact of regressive compliance costs. As noted previously, such data was not available for one of the four countries (the UK) and in two of the others (Australia and Canada) there were insufficient observations to be able to draw reliable conclusions. Based upon the evidence that is available, it does appear that the SBTCs may not be as effective as one would have hoped and is therefore an area that requires specific revenue authority/treasury attention. Judging from the overall responses, small businesses may not be too sure of the benefits offered by the SBTCs. This does not bode well for the government or the small business sector, as time and effort have been invested into these concessions and they do not, from the small businesses perspective, appear to be achieving at least one of their objectives — reducing the tax compliance burden for small businesses. Valuable time and resources are being spent on administering these concessions and if they are not meeting their intended purpose, these resources are being wasted to the detriment of the economy as a whole.

Further and more detailed research into the efficacy of special regimes for the small business sector is just one of the areas for future research that is highlighted by the current study. The more formal measurement of managerial benefits that derive from tax compliance is yet another area. Above all, there is a continued need for the tax compliance costs encountered by this critical sector of the economy to continue to be measured and monitored — across countries and over time — so that a light can continue to be shone upon these ‘hidden’ costs of taxation. In that way meaningful international comparisons can be made, “not to identify differences in compliance costs between countries, but to confirm the broad findings”, as Sandford most notably suggested (1995b, p. 407).

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## 8. APPENDIX A: SUMMARY OF THE SMALL BUSINESS TAX CONCESSIONS (SBTCs) IN AUSTRALIA, CANADA, SOUTH AFRICA AND THE UK 2010-2011

The broad nature (without delving into the qualifying requirements) of the major SBTCs (per country) are summarised below. Note that the schedule is not intended to be comprehensive and that some of these concessions have changed since the period of the study.

### Australian SBTCs

#### *GST concessions*

Three GST concessions are available to small businesses:

- GST accounting: a business need not register for GST if its GST turnover is less than A\$75,000. In addition, an entity taxpayer with turnover of less than A\$2 million per year can elect to account for and pay GST on a cash basis thereby accounting for GST when payments are made and sales are received;
- GST instalments: GST is payable by a business (turnover of less than A\$2 million per year) by means of quarterly instalments calculated by the ATO which saves the business time in working out the amount due to the ATO; and
- GST annual private apportionment: the ability to annually claim full GST credits for private purchases included in business purchases with only a single adjustment for this at end of the income year.

#### *Simplified capital allowances (depreciation)*

A small business can pool together most of its assets (into two pools: assets with a useful life less than 25 years which is depreciated at 30%; and a useful life greater than 25 years which is depreciated at 5%) and claim one deduction for the whole pool instead of for each individual asset as is the case normally. An outright deduction for assets costing greater than A\$1,000 is also available. A deduction at either 15% or 2.5% in the first year (regardless of when they were acquired during that year) is also permitted on most newly acquired assets.

#### *CGT concessions*

Four CGT concessions are available to small business entities. These concessions are:

- the CGT 15 year exemption – exemption from CGT when a business asset (continuously held for at least 15 years) is sold on retirement;
- the CGT 50% active asset reduction – a 50% reduction of the capital gain made on the sale of a business ('active') asset;
- the CGT retirement exemption – an exemption concession on the sale of a business asset, subject to a lifetime limit of \$500, 000; and
- the CGT rollover – deferral of a capital gain made on the sale of a small business asset to a later income year when a 'replacement' asset is acquired or an improvement is made to an existing asset.

*Entrepreneurs Tax Offset (ETO)*

Under the ETO provisions, eligible business taxpayers could obtain a reduction of up to 25% of their tax liability. Only taxpayers with an aggregated turnover of \$50,000 were eligible for the full concession. The ETO has subsequently been abolished.

**Canadian SBTCs***GST/HST concessions*

Two GST concessions are available for small businesses:

- GST accounting: a small supplier (essentially a business with total taxable revenues before expenses of C\$30,000 or less annually) need not register for GST. In addition a business with annual taxable supplies of not more than C\$200,000 can use the simpler Quick Method of accounting to calculate its GST; and
- GST instalments: GST is paid by means of annual as opposed to monthly or quarterly instalments calculated by the revenue authority if the annual taxable supplies of the business are C\$1,500,000 or less.

*Simplified capital allowance rules*

Computers and computer related equipment can be written-off entirely in a single year, as long as the purchase was made from January 27, 2009 to February 2011.

*CGT concessions*

Various forms of CGT relief are provided to entities operating Canadian small businesses:

- a lifetime capital gains exemption of C\$750,000 is available to investors on the capital gain made from the sale of qualified small business shares;
- allowable business investment loss: a capital loss made on the disposal of a share in a small business corporation or a debt due to a taxpayer from a small business corporation can be deducted from the taxpayer's other sources of income;
- small business rollover: a deferral of a capital gain made on the sale of a small business asset to a later income year when it is reinvested in other small business corporations; and
- capital gain reserve: a capital gain made on the transfer of small business corporation shares to a taxpayer's child is deferred over 10 years instead of over 5 years.

*Reduced corporate income tax and the small business deduction (SBD)*

Canadian-controlled private corporations that claim the SBD (which reduces the tax for which a company is liable) have lower tax rates than other corporations in Canada and generally have to make less tax payments (annually rather than monthly or quarterly) than larger businesses.

## South African SBTCs

### *VAT concessions*

Two broad VAT concessions are available for small businesses:

- VAT accounting: a business does not need to register for VAT, and is thus relieved of the administrative burden on this tax, if its taxable turnover is R1million or less. In addition, accounting for VAT on the payments basis allows business (sole proprietors with estimated annual taxable turnover of not more than R2.5 million) to account for VAT when amounts are received or payments are made instead of when an invoice is issued or received. The Small Retailers VAT Package (abolished from 1 March 2010) provided an alternative method for qualifying small retail businesses to determine the value of the total taxable supplies.
- VAT instalments: small businesses with a turnover of R1.5 million or less can submit and pay their VAT due every four months instead of every second month.

### *Special capital allowances and reduced corporate income tax rates*

Small businesses corporations (businesses with *inter alia* gross income of R14 million or less) receive immediate write off of manufacturing assets and an accelerated write off for other assets in comparison to other entities and pay tax at a lower rate than other similar entities.

### *CGT concession*

Relief is available in the form of an exclusion of R900,000 from a capital gain made by individuals who dispose of active business assets when they attain the age of 55 years, or where the disposal is in consequence of ill-health, other infirmity, superannuation or death.

### *Turnover Tax System*

This system allows micro businesses (businesses with qualifying income of R1 million or less) to be subject to a low rate of tax on turnover without having to keep a record of their expenses and deductions.

## UK SBTCs

### *VAT concessions*

Two broad VAT concessions are available for small businesses:

- VAT accounting: a business does not need to register for VAT, and is thus relieved of the administrative burden on this tax, if its taxable turnover is £77,000 or less. In addition, various VAT accounting schemes are available to UK small businesses. Examples are the flat rate scheme, the cash accounting scheme, the annual accounting scheme and retail schemes. Under the flat rate scheme, a business (with estimated annual taxable turnover of not more than £150,000 and business income of not more than £191,500) no longer has to keep record of the VAT it charges/pays per transaction, but



can calculate the VAT due by means of a percentage of the total VAT inclusive turnover. In terms of the cash accounting scheme (for businesses with an estimated turnover of £1.35 million or less), VAT only needs to be accounted for when amounts are received or payments are made. The annual accounting scheme (applicable to businesses with an estimated annual turnover of £1.35 million or less in the next tax year) requires submission of VAT returns only once at the end of the year as opposed to every quarter under the standard VAT system. Retail schemes allow the business to work out the value of its total VAT taxable sales for a period instead of for each and every retail sale it makes; and

- VAT instalments: in terms of the annual accounting scheme, VAT is paid by means of nine monthly or three quarterly interim payments as opposed to quarterly instalments.

#### *CGT concessions*

These UK concessions are available to all businesses and not specifically small businesses. Examples of these concessions are:

- Entrepreneur relief: this allows individuals and some trustees to claim relief on qualifying gains made on the disposal of all or part of a business, assets of a business after it has stopped trading or shares in a company; and
- Business asset roll-over relief: when a taxpayer disposes of a certain type of business asset, and replaces it with another asset that will be used in the business, the taxpayer can 'roll-over' or postpone the payment of any capital gains tax that would normally be due at that stage.

#### *Reduced corporate income tax rates*

Small businesses (those with profits not exceeding £300,000) pay tax at a lower rate than other corporations.

# Ethics codes and taxpayer charters: Increasing tax morale to increase tax compliance

Kirsty Unger<sup>1</sup>

## ***Abstract***

This paper considers ethics codes and taxpayer charters and outlines their objectives. A case study of Australia and the UK is conducted, discussing the ethics codes and taxpayer charters in place in these jurisdictions. Against this backdrop, the usefulness of these documents will be ruminated, and recommendations made as to how they could be enhanced =. Ultimately, it will be argued that these documents should form part of a well-functioning revenue administration, a necessary part of the balance between the powers given to the tax authority and the rights of the taxpayer that helps increase tax morale and, therefore, voluntary compliance of taxpayers.

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<sup>1</sup> Institutional Affiliations: Australian Taxation Office (the views and opinions expressed in this paper do not necessarily reflect the views of the Australian Taxation Office).

## 1. INTRODUCTION

In some countries (in some a lot longer than in others), there has been a continual change in mentality within revenue authorities, from primarily a discourse in deterrence to regarding the relationship with taxpayers as an ongoing co-operative partnership.<sup>2</sup> Of course, there is certainly still a divergence in strategies adopted by revenue authorities but ethics codes and taxpayer charters have become an increasingly popular part of this changing dynamic.<sup>3</sup> This paper considers these documents, analysing their objectives and usefulness. The implementation and operations of these documents in Australia and in the United Kingdom (UK) will be ruminated and findings of surveys and audits conducted in these jurisdictions discussed. Finally, recommendations are made as to how these documents may be enhanced. Ultimately, it will be argued that ethics codes and taxpayer charters are useful tools, in so far as they increase taxpayers' trust and confidence in the revenue administration, in turn increasing tax morale, which ultimately increases voluntary compliance.

## 2. WHAT ARE ETHICS CODES AND TAXPAYER CHARTERS?

From the mid-1970s academic and political research began to show a shift in public expectations of government; there was a push to raise government standards of performance, to operate in a more transparent way, to be more responsive to the needs and expectations of their 'customers' and to improve their complaints procedures.<sup>4</sup> There was an increasing recognition that fair and transparent tax collection is essential element of a legitimate government, as is taxpayer confidence in the revenue administration, particularly in a system of self-assessment, which relies on voluntary compliance.<sup>5</sup> Against this backdrop, many governments slowly began to draft codes and charters setting out ethical expectations for revenue administrators, how citizens can expect to be treated by the revenue administration, and giving a positive message about the mutual benefits of establishing a cooperative relationship.<sup>6</sup> Although there is borrowing of ideas from other countries, there is not a rigid template as to the structure or content of the documents.<sup>7</sup> As there are distinctions between ethics codes and taxpayer charters each will be discussed in greater detail below.

### 2.1 Ethics codes

The codification of ethical conduct for the public service takes a variety of forms internationally, from a 'ten commandments' approach, covering a small number of broadly expressed ideas, to comprehensive coverage of ethical rules with guidelines

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<sup>2</sup> Valerie Braithwaite, 'Are taxpayers' charters 'seducers' or 'protectors' of public interest? Australia's experience' (Working Paper No. 70, Centre for Tax System Integrity, 2005) 1.

<sup>3</sup> Ibid.

<sup>4</sup> Amardeep Dhillon and Jan Bouwer, 'Reform of tax administration in developing nations' in B Dustrud and L Barr (eds) *Revenue Matters: A guide to achieving high performance under taxing circumstances* (Montgomery Research, 2005).

<sup>5</sup> Deborah Brautigam, Odd-Helge Fjeldstad and Mick Moore, *Taxation and State-building in developing countries* (Cambridge University Press, 2008) 1

<sup>6</sup> Braithwaite, above n1.

<sup>7</sup> Gavin Drewry 'Citizen's charters: service quality chameleons' (2007) 7(3) *Public Management Review* 321, 322.

for their implementation.<sup>8</sup> Their application varies in each country, some countries relying more on legislation to regulate public service ethics through various acts and regulations than others.<sup>9</sup> Countries such as Australia and New Zealand have broad public service wide codes of conduct from which individual agencies can implement customized codes to reflect their particular requirement, whereas in other countries, such as Norway, codes are agency based.<sup>10</sup> Although different countries emphasize different issues in their codes, commonalities in focus are apparent; they address issues of integrity, fairness, accountability and professionalism.<sup>11</sup> They also use the terms ‘ethics’ and ‘values’ interchangeably.<sup>12</sup> Codification of ethics is designed to define a “way of doing things for the public service, shaping a high performing government as a whole”.<sup>13</sup> In doing so, they inspire public confidence in the government’s integrity, ultimately building trust among the citizens.<sup>14</sup>

## 2.2 Taxpayer charters

Whereas ethics codes represent an internal governance of the public sector (and more narrowly, the revenue administration), taxpayer charters are designed by the government to foster the relationship between taxpayers and the revenue administration.<sup>15</sup> They state what is expected by both officials and taxpayers.<sup>16</sup> Globally, they share key characteristics, including clear and simple language, realistic and measurable performance standards; a dedicated grievance redress mechanism, and an effective public relations strategy to increase users’ awareness about the charter.<sup>17</sup> The OECD notes that ‘most taxpayers’ charters are a guide to the law and are not legal documents in themselves, although in some tax systems they may constitute a ‘ruling’. Generally, they would not provide additional rights or obligations other than those contained in relevant legislation.<sup>18</sup> In 2003, the OECD published an example Taxpayers’ Charter. This document would obviously need to be tailored to reflect the relevant policy and legislative environment, administrative practices and culture of the revenue administration trying to use it, but it does provide a sound starting place for

<sup>8</sup> Andrew Kakabadse, Nada Korac-Kakabasde and Alexander Kouzmin ‘Ethics, values and behaviours: comparison of three case studies examining the paucity of leadership in government’ (2003) 81(3) *Public Administration* 477, 481.

<sup>9</sup> Jacques van Blijswijk, Richard van Breukelen, Aimee Franklin and Jos Raadschelders ‘Beyond Ethical Codes: The Management of Integrity in the Netherlands Tax and Customs’ (2004) 64(6) *Public Administration Review* 718, 718.

<sup>10</sup> Kakabadse, Korac-Kakabasde and Kouzmin above n7.

<sup>11</sup> Kenneth Kernaghan ‘Integrating Values into the Public service: the values statement as centrepiece’ (2004) 63(3) *Public Administration Review* 711, 712.

<sup>12</sup> Ibid.

<sup>13</sup> Australian Public Service Commission, *Leaving and shaping a unified, high performing APS* <[www.apsc.gov.au/publications-and-media/current-publications/aps-values-and-code-of-conduct-in-practice/the-apsdefined-by-values](http://www.apsc.gov.au/publications-and-media/current-publications/aps-values-and-code-of-conduct-in-practice/the-apsdefined-by-values)>.

<sup>14</sup> Ralph Heintzman, ‘Public service values and ethics’ (2008) 50(4) *Canadian Public Administration* 573, 596.

<sup>15</sup> van Blijswijk, van Breukelen, Franklin and Raadschelders above n8.

<sup>16</sup> Centre for Tax Policy and Administration ‘Taxpayers’ rights and obligations – practice note’ (OECD Committee of Fiscal Affairs Forum on Tax Administration, 2003) 3.

<sup>17</sup> David Post and Sanjay Agarwal, *Citizen Charters: enhancing service delivery through accountability* (2011) The World Bank

<<http://www-esd.worldbank.org/sdvpubs/index.cfm?Page=Search&DocID=577>>.

<sup>18</sup> OECD above n15, 4.

countries looking to implement a charter. It also provides a criterion against which countries with a pre-existing charter can assess their document.<sup>19</sup>

Interestingly, a Model Taxpayer Charter of taxpayer rights and responsibilities that can be adapted for participating nations has recently been drawn up by professional bodies representing more than half a million tax advisors worldwide.<sup>20</sup> Copies of the preliminary report have been sent to delegates of the countries who participated in the surveys, as well as the European Union (EU), the Organization for Economic Co-operation and Development (OECD), the United Nations Fiscal Affairs Committee, the World Bank, the International Monetary Fund (IMF) and other interested stakeholders.<sup>21</sup> David Russell, co-author of the report said “in the absence of an appropriate balance between revenue authorities and taxpayers, the essential trust required for efficient administration of the tax laws will continue to be eroded”, and he hopes this charter will become a mechanism to address this concern.<sup>22</sup> It will be interesting to monitor how the report is received by the international bodies, and whether any action is taken to establish it as international guidelines for the drafting of charter documents based on this document.

Before analysing the usefulness of ethics codes and taxpayer charters, and recommending enhancements, the next section will provide a case study of Australia and the UK who both have an ethics code and taxpayer charter. These countries have been chosen for the case study as they have had two very different experiences with a taxpayer charter. As will be demonstrated, the taxpayer charter in Australia has proved successful by objective measures, and is considered exemplary in contrast to the UK. These differences will provide context for the overall discussion as to whether or not the documents are useful, as well as when recommending enhancements.

### 3. A COMPARATIVE ANALYSIS — AUSTRALIA AND THE UK

The Australian and UK tax systems share a common cultural tradition in many ways. The development of the Australian tax system was, after all, heavily influenced by that of the ‘mother country’.<sup>23</sup> More recently, the UK system has been strongly influenced by Australian practices, such as the establishment of the electronic lodgement of tax returns. Given the closeness of the two jurisdictions, it is interesting to see the divergence in approaches, particularly at the level of the taxpayer charter.

<sup>19</sup> Ibid.

<sup>20</sup> Raymond Doherty ‘International tax charter published’ *Economic Voice* (online) 13 May 2013 <<http://www.economicvoice.com/model-taxpayer-charter-to-promote-greater-fairness-in-taxation-across-the-world/50036937#axzz2TQVyStLz>>.

<sup>21</sup> Ibid.

<sup>22</sup> ‘Model taxpayer charter to promote fairness in taxation across the world’, *Step Journal* (online) 13 May 2013 <[http://www.stepjournal.org/news/news/main\\_story/model\\_taxpayer\\_charter\\_to\\_prom.aspx?link=news\\_headline](http://www.stepjournal.org/news/news/main_story/model_taxpayer_charter_to_prom.aspx?link=news_headline)>.

<sup>23</sup> Simon James, Thamrongsak Svetalelkth and Brian Wright, ‘Tax Charters, performance indicators and the case for a more strategic approach to tax administration’ (2007) 4 <<https://eric.exeter.ac.uk/repository/handle/10036/47455>>.

### 3.1 Australia

The Australian Taxation Office (ATO) is subject to both an ethics code and a taxpayer charter. The ethical framework is established in the Australian Public Service (APS) Values and APS Code of Conduct, which are set out in section 13 of the *Public Service Act 1999* (Cth). This ethics code applies to all federal public servants. The Taxpayer Charter, drafted in the late 1990s, provides a set of administrative guidelines of best practice for officers of the ATO. When it was drafted, a significant number of taxpayers argued for a Charter enshrined in legislation, but this was not supported by the ATO, which drafted the Charter in its current state.<sup>24</sup> In both documents, because the values are principles-based, their application in particular circumstances is “broadly up to the officer applying them; but there are sanctions for failing to conform”.<sup>25</sup>

#### 3.1.1 The APS Values and APS code of conduct (ethics codes)

Australia is noted as being amongst the first of the OECD countries to develop an ethical structure to assist public servants. The Australian *Public Service Act*<sup>26</sup> contains a clear code of conduct for all public servants, with the capacity for agencies to supplement the code.<sup>27</sup> The knowledge among federal public servants of the ethics code is tested annually and, in accordance with the *Public Service Act*<sup>28</sup>, a report is presented to Parliament outlining the findings. Encouragingly, the latest results show that there has been a growing recognition of the ethics code, and significant improvements in compliance with it.<sup>29</sup> Eighty-four per cent of employees agree their agency actively encourages ethical behaviour by all its employees, and 58 per cent agreed senior managers in their agency led by example in terms of ethical behaviour.<sup>30</sup> Of course, whilst these results are excellent, they do not provide an objective evaluation of the effectiveness of the ethical codes, rather they are subjective evaluations by the officers themselves.<sup>31</sup> A more objective measure can be found in the number of breaches of the ethics code, which are progressively decreasing, particularly in the ATO.<sup>32</sup>

Further, in 1997, the OECD published an ethics checklist, which enables governments to measure their ethics systems ‘against a series of yardsticks, the systems they have in place for setting ethical standards, for fostering ethical behaviour and monitoring ethical health, for dealing with misconduct and for keeping the public informed’.<sup>33</sup>

<sup>24</sup> Duncan Bentley ‘Formulating a taxpayers’ charter of rights: setting the ground rules’ (1996) 25(3) *Australian Tax Review* 97, 97.

<sup>25</sup> Kathy McDermott, *Whatever happened to Frank and Fearless?: The impact of new public management on the Australian Public Service* (The Australian National University, 2008) 11.

<sup>26</sup> 1999 (Cth).

<sup>27</sup> Kakabadse, Korac-Kakabasde and Kouzmin above n7, 483.

<sup>28</sup> 1999 (Cth).

<sup>29</sup> Australian Public Service Commission, ‘Employee survey results – state of the service series 2010–11’ (24 November 2011) 4

<[http://www.apsc.gov.au/\\_\\_data/assets/pdf\\_file/0018/5913/employeesurvey.pdf](http://www.apsc.gov.au/__data/assets/pdf_file/0018/5913/employeesurvey.pdf)>.

<sup>30</sup> Ibid.

<sup>31</sup> Lynelle Briggs ‘Public Sector ethics in the 21<sup>st</sup> century: the new vulnerabilities’ (2008) *Public Administration Today* 23, 25.

<sup>32</sup> Australian Taxation Office *Guide to managing suspected misconduct in the ATO* (October 2012) Australian Services Union 4 <<http://asutax.asn.au/doc/misconductpractitionerOct.pdf>>.

<sup>33</sup> Lynelle Briggs ‘Testing APS Ethics: Where’s the Integrity’ (2009) 68(2) *Australian Journal of Public Administration* 119, 122.

The literature suggests that against this, the Australian ethics code measures up fairly well, that the Australian public is aware of the code, the code has become entrenched and compliance with the code is high.<sup>34</sup> Without a doubt, this knowledge has improved the public's trust in the ATO, and it is inferred that this has led to increased compliance with the taxpayer.<sup>35</sup>

### 3.1.2 *The Taxpayer Charter*

The ATO was the first Australian government agency to develop a charter of rights and responsibilities to supplement the APS Values and Code of Conduct. The Taxpayer Charter, first published in 1997, like most charters, represents standards which the ATO states it will meet in its daily performance and interaction with taxpayers, as well as establishing the organization's expectations of taxpayers.<sup>36</sup> The current charter consists of 13 principles: treat taxpayers fairly and reasonably, treat taxpayers as being honest unless they act otherwise, offer taxpayers professional service and assistance, accept taxpayers can be represented by a person of their choice and get advice, respect their privacy, keep the information the ATO hold about taxpayers confidential, give taxpayers access to information held about them by the ATO, help taxpayers get things right, explain the decisions the ATO makes about taxpayers, respect taxpayers' right to a review, respect taxpayers' rights to make a complaint, make it easier for taxpayers to comply and be accountable.

Initially there was a view that the Charter was merely a passing phase but it has gained acceptance and support from ATO staff over time.<sup>37</sup> Research has shown that shortly after its introduction, 21 per cent of taxpayers generally said that they had heard of the Charter, and of those taxpayers who had had direct contact with the ATO, the figure was 27 per cent.<sup>38</sup> Since its introduction, the ATO has reviewed the Taxpayer Charter twice, and made changes to the Charter's presentation, however, the underlying themes and commitments remain the same as they were in 1997.<sup>39</sup>

In 2000, the Centre for Tax System Integrity, in partnership with the ATO and the Australian National University, conducted *The Community Hopes, Fears and Actions* survey, developed to obtain "a snapshot of the beliefs, attitudes, values and motivations held by Australian citizens in relation to the ATO, the tax system and Australian democracy".<sup>40</sup> Questions about the Taxpayer Charter were asked in this survey.<sup>41</sup> A follow up survey was conducted between November 2001 and February 2002. When presented with the then 12 principles of the Taxpayer Charter, survey respondents indicated that on a scale of one (almost never) to five (almost always), they felt that the ATO generally meets its obligations (the average of the surveys being

<sup>34</sup> Ibid.

<sup>35</sup> Michael D'Ascenzo, *Compliance Program 2012-13*, Australian Taxation Office, 19 July 2012 <<http://www.ato.gov.au/taxprofessionals/content.aspx?doc=/content/00326650.htm&mnu=53243&mfp=001/005>>.

<sup>36</sup> Margaret McLennan 'The principles and concepts in the development of the Taxpayers' Charter' (2003) 32 *Australian Tax Review* 22, 22.

<sup>37</sup> Simon James, Kristina Murphy and Monika Reinhart 'The Taxpayer Charter' (2004) 7(2) *Journal of Australian Taxation* 336, 341.

<sup>38</sup> Ibid.

<sup>39</sup> The Australian Taxation Office, *The Commissioner of Taxation Annual Report* (25 October 2005) <[http://www.ato.gov.au/corporate/content.aspx?doc=/content/64667.htm&page=77&H4\\_7\\_6](http://www.ato.gov.au/corporate/content.aspx?doc=/content/64667.htm&page=77&H4_7_6)>.

<sup>40</sup> Valerie Braithwait, 'The Community Hopes, Fears and Actions survey: goals and measures' (Working Paper No 2, Australian National University and Australian Taxation Office, March 2001) 1.

<sup>41</sup> James, Murphy and Reinhart, above n36.

3.5), at least most of the time.<sup>42</sup> This is quite clearly a positive result. What is less positive is the fact that there is an apparent fall in mean rating between the 2000 and 2002 surveys.<sup>43</sup> The reasons for this drop are not clear.<sup>44</sup>

In addition to these public surveys, the Australian National Audit Office (ANAO) has conducted several performance audits of the ATO and its compliance with the Taxpayer Charter. The most recent audit was conducted in 2007-08, which was a follow up audit to that conducted in 2004-05.<sup>45</sup> The findings of the 2004-05 audit indicated that the ATO is managing its responsibilities under the charter, and that they have systems and processes in place to develop, maintain and review the Charter.<sup>46</sup> Importantly, the audit found the ATO to be committed to the Charter principles, encouraging mutual trust and respect with the taxpaying community.<sup>47</sup>

### 3.2 United Kingdom

The UK has adopted a different approach to Australia, with regards to expressing ethics and taxpayer rights, which has not proved to be as successful. Firstly, its overarching charter, the Citizen's Charter, first appeared in 1991 and was intended specifically to achieve better quality and more responsive public services.<sup>48</sup> The former revenue administration, Inland Revenue, introduced a Taxpayer Charter in line with the Citizens' Charter not long after its publication.<sup>49</sup> Surprisingly, it would appear that references to the Citizen's Charter are seldom heard today, and it would almost appear that the Charter never existed.<sup>50</sup> The same can be said of the Taxpayer Charter, the status of which remained ambiguous after the amalgamation of the Inland Revenue with Customs and Excise in 2005.<sup>51</sup> In fact, some literature suggests that the charter was abandoned as early as 1997, after New Labour came into power.<sup>52</sup>

Over a decade later, the Her Majesty's Revenue and Customs (HMRC) announced in 2008 that it would enshrine a list of basic rights in a new taxpayers' charter to fill the void.<sup>53</sup> However, this Charter has been criticised, commentators noting that the summary does not make it clear that a taxpayer has obligations as well as rights, nor does the text make it as clear as it might that tax compliance is what is expected of the people.<sup>54</sup> It was hoped that the Charter would provide further protection of taxpayers'

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<sup>42</sup> Ibid.

<sup>43</sup> Ibid, 343.

<sup>44</sup> Ibid.

<sup>45</sup> Auditor General 'Taxpayers' Charter: Australian Taxation Office' (Audit Report No 19. 2004-05) 5.

<sup>46</sup> Ibid.

<sup>47</sup> Ibid.

<sup>48</sup> Simon James, Kristina Murphy and Monika Reinhart 'The Citizen's Charter: how such initiatives might be more effective' (Working Paper 65, The Australian National University, May 2005)13.

<sup>49</sup> The Chartered Institute of Taxation *A taxpayers' charter for the United Kingdom*, 2008  
<<http://old.tax.org.uk/attach.pl/6595/7717/CIOT%20Paper%20-%20Taxpayers%20Charter%20Feb%2008.pdf>>.

<sup>50</sup> Drewry, above n6, 330.

<sup>51</sup> The Chartered Institute of Taxation, above n48.

<sup>52</sup> Phillip Inman, 'Government agrees to taxpayer charter', *The Guardian* (online) 10 January 2008 <<http://www.guardian.co.uk/business/2008/jan/10/2>>.

<sup>53</sup> Ibid.

<sup>54</sup> Richard Murphy, *HMRC Charter* (28 November 2009) Tax Research UK  
<<http://www.taxresearch.org.uk/Blog/2009/11/28/hmrc-charter/>>.



rights, but the HMRC Charter that has resulted is very weak.<sup>55</sup> Its language is unclear and the content is primarily directed at the revenue administration, seemingly missing the point that the Charter is primarily for the taxpayers, not the HMRC staff.<sup>56</sup> Many have suggested that this charter, like the former charter, is merely a passing phase, and it will shortly fall into disuse.<sup>57</sup>

Reference to ethics can be found in the *Civil Service Code*, adopted in 1996. Unlike the APS Values and Ethics Code, the *Civil Service Code* gives pride of place to democratic and ethical values, but pays little attention to professional values.<sup>58</sup> There is an expectation that all departments and agencies incorporate the code into their employees' conditions of service, to clarify appropriate standards of conduct and the sanctions for breaking them.<sup>59</sup> As in Australia, regular surveys and audits are conducted to ensure compliance with the Code. The three most recent surveys of public servants demonstrate a growing awareness of, and confidence in, the Code.<sup>60</sup> Surveys have also shown that the public is comfortable that the code promotes ethical behaviour within the public service, and that the enforcement provisions are sufficient.<sup>61</sup> The fact that the code does not address professional values, however, is of concern and potentially affects the usefulness of the code.<sup>62</sup>

The above discussion has demonstrated the increasing awareness of the need for ethical conduct by public servants and the rights of taxpayers, and how this awareness has manifested itself in Australian and the UK. Many of the findings emerging from the surveys, reports and audits support discussions by academics of the effectiveness and usefulness of ethics codes and taxpayer charters generally. These are discussed in the next section. Furthermore, the history of the Taxpayer Charter (and, to a certain extent, the ethics code) in the UK provides useful lessons which will be discussed when recommendations are made later in the paper.

#### 4. BUT ARE THEY USEFUL?

It is widely recognised that “finding good measures of effectiveness and usefulness is not easy, and all performance indicators have their weaknesses and limitations”.<sup>63</sup> However, it is argued that ethics codes and taxpayer charters are useful but for two different reasons which are explored below.

<sup>55</sup> Judith Freedman and John Vella ‘HMRC’s management of the UK tax system: the boundaries of legitimate discretion’ (Legal Research Paper Series, Paper No. 73/2012, University of Oxford, November 2012) 87.

<sup>56</sup> John Whiting ‘section 92 – HMRC Charter – Magna Carter the second?’ (2009) 5 *British Tax Review* 616, 619.

<sup>57</sup> Ibid.

<sup>58</sup> Kenneth Kernghan ‘Integrating values into the public service: the values statement as centrepiece’ (2003) 63(6) *Public Administration Review* 711, 714.

<sup>59</sup> Kenneth Kernghan ‘Encouraging ‘rightdoing’ and discouraging wrongdoing: a public service charter and disclosure legislation’ 2 *The Public Service and Transparency* 73, 74.

<sup>60</sup> Civil Service Commission ‘Annual Report and Accounts 2011–12’ (12 July 2012) 27 <<http://civilservicecommission.independent.gov.uk/wp-content/uploads/2012/07/CSC-Annual-Report-2011-12.pdf>>.

<sup>61</sup> Ibid.

<sup>62</sup> Kernghan, above n57, 715.

<sup>63</sup> Michael D’Ascenzo, ‘Sustaining good practice tax administration’ (Speech delivered at Australasian Tax Teachers Association Conference, New Zealand, 20 January 2009) <<http://www.ato.gov.au/corporate/content.aspx?doc=/content/00176063.htm>>.

## 4.1 Ethics codes

Empirical research strongly supports the notion that ethics can be taught.<sup>64</sup> Because of this, research also shows that an ethical code which persuasively addresses the range of approaches a public servant uses to analyse ethical questions becomes the foundation for an ethical public service.<sup>65</sup> Ethical education within the public service is far more effective if it is based on codes that can be understood by all public servants.<sup>66</sup> When introducing a code of conduct, particular care must be taken to account for values that are already entrenched in the public service to avoid confusion, which could lead to ineffectiveness.<sup>67</sup> A recent study of European countries revealed a number of countries using ethics code revisions and implementations as the backbone to government reforms.<sup>68</sup> They can also be the catalyst for legal reform, as well as used as a management tool, particularly in developing nations who may not have made the psychological shift to being public servants.<sup>69</sup>

The greatest benefit of an ethical code, however, is their ability to create a shared moral consciousness among tax officers.<sup>70</sup> There are those who view tax codes as having little value, believing that they are either too abstract to guide tax administrators in specific situations, or too specific, providing guidance only for one particular case and being silent on appropriate behaviour in other situations.<sup>71</sup> Whilst this criticism may be true of some codes, it is argued that codes are not meant to provide a comprehensive set of rules. Rather, they focus on the key values the government wants to promote and the behaviours it wants to prohibit. In day-to-day practice, there is a need for employees to have discretion but this discretion is better exercised when a shared moral consciousness has been developed throughout the organisation.<sup>72</sup> It is particularly important that the ethics code is fostered by the senior management of the revenue administrator; the mere existence of an ethics code will not be useful or effective. However, If the revenue administration is seen to generally comply with the ethics code and that ethics code is able to be (and is) legitimately enforced in the event of non-compliance, public trust is increased.<sup>73</sup> This premise is supported by the data from Australia and UK.

## 4.2 Taxpayer charters

The concept of a taxpayer charter articulates the relationship between the revenue administrator and the taxpayer.<sup>74</sup> Many of the comments made above in relation to the benefits of a code hold true for taxpayer charters. That is, they provide a foundation

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<sup>64</sup> Stuart Gilman, 'Ethics Codes and Codes of Conduct as tools for promoting an ethical and professional public service: comparative successes and lessons' (Report prepared for the PREM, World Bank, Washington, 2005)3.

<sup>65</sup> Ibid.

<sup>66</sup> Kenneth Kernaghan above 58.

<sup>67</sup> Gilman, above n63, 25.

<sup>68</sup> Jolanta Palidaukaite 'Codes of Conduct for public servants in eastern and central European Countries: Comparative Perspective' <<http://www.oecd.org/mena/governance/35521438.pdf>>.

<sup>69</sup> Gilman, above n63, 32.

<sup>70</sup> Public Administration Select Committee 'From citizen's charter to public service guaranteed: entitlements to public services' (House of Commons, Twelfth Report of Session 2007–08, 15 July 2008) 5.

<sup>71</sup> van Blijswijk, van Breukelen, Franklin and Raadschelders above n 8, 718.

<sup>72</sup> Ibid.

<sup>73</sup> Palidaukaite above n67.

<sup>74</sup> Public Administration Select Committee above n68.

for education of public servants as well as taxpayers and can assist in government reforms, as well as assisting developing countries in the transition to a 'public service'.<sup>75</sup>

Most importantly, however, is the ability of a taxpayer charter to become a symbol of a partnership between taxpayers and the revenue administrator.<sup>76</sup> It is impossible to consider that parties in the tax relationship are on equal footing; the State undeniably has a position of power.<sup>77</sup> Although legislation generally provides for various appeal routes and safeguards, these are only useful if one knows them and can access them.<sup>78</sup> Otherwise, a charter is a necessary part of a modern tax system, a clearly identifiable statement addressing the balance between the powers given to the tax authority and the taxpayer's rights.<sup>79</sup> Crucially, it helps the taxpayer, particularly those who are unrepresented, find their rights and act as a defence, if needed, against an overbearing tax authority.<sup>80</sup> Furthermore, a taxpayer charter plays a key role in self-assessment tax regimes, which require a taxpayer to perform functions and exercise some responsibilities that might otherwise be undertaken by the revenue administrator.<sup>81</sup>

It is often suggested that in the international context, the absence of any international statement or covenant on taxpayer's rights, means taxpayers cannot (and perhaps should not) expect consistent treatment in their affairs from nation to nation.<sup>82</sup> Taxpayers are increasingly involved in transactions and activities that bring them to the attention of revenue authorities outside their own jurisdiction so having consistency is important. This is arguably a significant downfall of a taxpayer charter at the state level. However, the Model Taxpayer Charter may address this concern, depending on the response to this document by the relevant global bodies. At any rate, in so far as taxpayer charters are based on the OECD model (or indeed charters adopted in other jurisdictions), there should be identifiable consistencies between the global documents.

In summary, it is argued that ethics codes are useful, in the sense that they create a moral compass within the revenue administration. A taxpayer charter, which supplements an ethics code, is a clearly an identifiable symbol of the revenue administrator's and taxpayer's partnership, and helps address the unevenly distributed balance of power between the two. Literature published in the realm of tax compliance indicates that tax morale plays a major role in voluntary tax compliance, which is affected by perceptions of procedural justice, trust, belief in the legitimacy of the government and so on.<sup>83</sup> Inferences drawn from the evidence suggest that the combination of an ethics code and taxpayer charter increases tax morale, and therefore voluntary compliance.<sup>84</sup> Although it must be recognised that what works in one

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<sup>75</sup> Ibid, 9.

<sup>76</sup> Braithwaite above n1, 25.

<sup>77</sup> Maria Roch, 'Tax administrator vs Taxpayer: a new deal' (Speech delivered at the Manfred Moessner Lecture, Rotterdam, 2 June 2012).

<sup>78</sup> Whiting above n55, 617.

<sup>79</sup> Ibid.

<sup>80</sup> Ibid.

<sup>81</sup> Australian National Audit Office 'Taxpayers' charter – follow up audit' (Audit Report No.40 2007–08) 36.

<sup>82</sup> Drewry above n6, 330.

<sup>83</sup> Marjorie Kornhauser 'A Tax Morale Approach to Compliance: Recommendations for the IRS' (2007) 8(6) *A Tax Morale Approach to Compliance* 599, 601.

<sup>84</sup> Benno Torgler and Kristina Murphy 'Tax Morale in Australia: what shapes it and has it changed over time?' (2004) 7(2) *Journal of Australian Taxation* 298, 332.

national context may not work in another, and that the purpose and context of the documents is driven by jurisdictional politics, it is reasonable to conclude that the Australian experience supports this position.<sup>85</sup> Improving voluntary tax compliance is the ultimate objective for any revenue administration. Voluntary compliance is essential, as this is the most cost effective and efficient method of tax collection. Ergo, it is concluded that ethics codes and taxpayer charters are useful.

## 5. RECOMMENDATIONS

It is difficult to make broad statements as to how ethics codes and taxpayer charters could be enhanced, given that they differ from jurisdiction to jurisdiction, and different revenue administrations face different challenges and constraints. However, there are reoccurring criticisms of each document. Ethics codes are often criticised as having too many statements of values. If they are too open-ended it becomes too easy for public servants to justify any action; it gives them too many values to which they can attach an argument for or against a proposed action or a particular rule.<sup>86</sup> In other words, the public servant may value-shop.<sup>87</sup> The code is therefore meaningless, carrying no obligation. To prevent this from occurring, codes should be enhanced through constant review and revision, through extensive consultation with public servants and other relevant stakeholders.<sup>88</sup> Codes could also be enhanced by increasing the clarity with which messages are presented, and avoiding an excessively long code.<sup>89</sup> As has already been stated, it is widely agreed that Australia provides an excellent example of how best to do this.<sup>90</sup>

There have also been criticisms made of the content of codes, given that a code should influence the decision making process of the public servant. It is suggested that making statements such as 'be honest', and 'obey the law' is ineffective, as this is merely restating commonly held community expectations, and therefore avoided.<sup>91</sup> However, statements of professional values are important (such as setting out the expectations for professional communications), certainly an enhancement that could be made in the UK.<sup>92</sup> Another way to enhance codes is to improve the enforcement provisions. A strong enforcement provision makes unethical action less desirable to the public servant.<sup>93</sup> Again, the Australian ethics codes are cited as good examples of how to achieve this.<sup>94</sup>

It is suggested that these enhancements are also broadly applicable to taxpayer charters, and probably would go a way to addressing many of the concerns regarding the UK Taxpayer Charter. In addition, it is often suggested that taxpayer charters could be enhanced by having legal force, rather than simply being a guide to the law. However, it is argued that this is not necessary; in fact, this could work against the

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<sup>85</sup> Drewry above n6, 338.

<sup>86</sup> Ralph Heintzman above n13, 582.

<sup>87</sup> Ibid.

<sup>88</sup> CTL Leisewitz, *Criticisms of a code of ethics* 2007  
<[wiredspace.wits.ac.za/bitstream/10539/2203/26/20Chapter20.pdf](http://wiredspace.wits.ac.za/bitstream/10539/2203/26/20Chapter20.pdf)>.

<sup>89</sup> John St. Cloud 'Changing Behaviour by improving codes of ethics' (2007) 22(2) *American Journal of Business* 23, 25.

<sup>90</sup> OECD, *Managing conflict of interest in the public service* (OECD Publishing, 2004) 62.

<sup>91</sup> St. Cloud above n88, 27.

<sup>92</sup> Ibid.

<sup>93</sup> Ibid.

<sup>94</sup> Ibid, 29.

purpose of the documents, as they can only be developed laboriously, through prescribed law amendment channels.<sup>95</sup> The lesson may also be drawn from the taxpayer charter in the UK that the document needs to be clear that taxpayers have obligations as well as rights enshrined. Another shortfall of taxpayer charter generally is that they do not address how the revenue administration can re-engage taxpayers who have become disassociated from the tax system. Addressing this would further enhance the document.

Of course, the problems within the UK revenue administration go far beyond the lack of an effective ethics code and taxpayer charter; factors such as ambitious IT programs, significant resource cuts and a detrimental management culture are recognised to have played a significant role.<sup>96</sup> Recently, a report released by the Independent Adjudicator (the de facto watchdog that investigates the way that HMRC staff handle disputes) was scathing in its appraisal of the performance of staff in their dealings with the public.<sup>97</sup> This shortcoming is attributed to the massive increase in complexity of the tax system over the past 15 years.<sup>98</sup> Nevertheless, it is argued that had more effective documents been in place, the situation may not have become so disturbing. For example, expectations in relation to management structure and standards, and the delivery of services to the taxpayer would have been clear and well established.<sup>99</sup> Therefore, it is argued that enhancing both the ethics code and the taxpayer charter (adopting the suggestions made above) would be a valuable starting point to repairing the revenue administration in the UK going forward.

In summary, it is difficult to make suggestions as to how ethics codes and taxpayer charters could be enhanced without knowing the context of the document in the relevant jurisdictions revenue administration. However, broadly speaking, it is argued that the documents could be enhanced, that is, further change the behaviour of those covered, by making changes to content and enforcement mechanisms. Additionally, taxpayer charters need to ensure that it is clearly states that the taxpayer has obligations and not just rights, and address taxpayers who have become disassociated from the tax system.

## 6. CONCLUSION

Ethics codes, properly drafted, are the ultimate term of reference for tax administrators, the framework upon which the tax system is built. A well drafted taxpayer charter supplements an ethics code, and provides a clearly identifiable statement addressing the balance between the powers given to the tax authority and the taxpayer's rights. This paper considered such documents in the Australian and UK context. Australia's ethics codes and taxpayer charter are considered exemplary examples of how such documents should be drafted and operate. Anecdotal evidence from surveys and audits conducted in Australia suggest that these documents are having a resounding

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<sup>95</sup> Whiting above n55, 617.

<sup>96</sup> Simon James, 'Behavioural economics and risks of tax administration' (2012) 10(2) *eJournal of Tax Research* 345, 353.

<sup>97</sup> Sam Dunn, 'We fought HMRC over a £10,000 bill for four years: official report reveals how the taxman wrongly rejected thousands of legitimate claims' *This is Money* (online) 1 October 2013 <<http://www.thisismoney.co.uk/money/news/article-2440395/Taxman-wrongly-rejects-thousands-complaints-reveals-official-report.html>>

<sup>98</sup> Ibid.

<sup>99</sup> James above n96.

impact on not only the internal operations of the ATO, but the levels of trust within the community as well. Although the ethics code in the UK has to some extent had similar results (although there is certainly room for improvement), the same cannot be said of its taxpayer charter. Nevertheless, codes and taxpayer charters can have a lasting impact on the culture of the organisation, and taxpayers.<sup>100</sup> As such, they are useful documents, increasingly the cornerstone of a modern tax system which helps in improving voluntary compliance by improving tax morale.

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<sup>100</sup> van Blijswijk, van Breukelen, Franklin and Raadschelders above n8, 718.

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# The compliance costs of Value Added Tax (VAT): The case of the Republic of Mauritius

Dr Kumari Juddoo<sup>1</sup>

## ***Abstract***

The evaluation of taxpayers' compliance costs has grown in significance within the tax system research over more than two decades and has predominantly emanated from developed countries. However, compliance costs literature is quite limited in developing countries. This article measures the compliance costs of the Value Added Tax (VAT) for the Republic of Mauritius for the period of 2001/2002, and using consumer price index has estimated the compliance costs for the year to 2009/2010. It also measures the net compliance costs after the effect of the benefits to the VAT registered traders. The regressive effect of compliance costs is proven, measured by the different categories of traders and the number of employee. A regression model estimating the magnitude of total compliance costs was also formulated with the turnover level, number of invoices and methods of recording as significant indicators.

**Keywords:** Compliance costs, VAT

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<sup>1</sup> MSc; BSc; FCCA; PhD.

## 1. INTRODUCTION

The imposition of taxes represents a transfer of resources from households and businessmen to the Government. Taxation is an inevitable instrument in modern economies to fund public spending and meet fundamental economic and social objectives. It is one of the main tools used by government in financing of public administration, managing monetary policy, funding social and economic services, and the maintenance of welfare state. Import tariffs and excise duties often constitute the most important revenue sources in many developing countries. This trend however has faced a recent significant challenge, as many of the developing countries are now either lowering their trade taxes or replacing them with the consumption-type Value Added Taxes (VAT), sometimes referred to as the Goods and Services Tax (GST). This shift helps in reducing economic distortion caused by trade tariffs which are now largely discredited in the modern world economy and are increasingly regulated by the World Trade Organisation (WTO). Tax simplicity has long been viewed as good tax policy and researchers in finance have been studying the magnitude and sources of these taxes and the implying costs.

Research in compliance costs in countries in transition (CITs) is a relatively new phenomenon. The main reason for a previous lack of interest in such studies is a shortage of experts, cooperation of tax authorities, non-existent or old survey data and constant changes in the tax system. The Republic of Mauritius, like other developing countries, has also witnessed some evolution of the tax system by replacing the retail sales tax and reducing the trade tariffs and excise duties. Therefore a first study on compliance costs for VAT for the Republic of Mauritius is highly commendable and may be helpful in tax policy and tax reform.

### 1.1 Research objectives

This paper is based on the estimation of the compliance costs as depicted by Prof Sandford's (1973) study and it is one of the first studies on taxation for Mauritius. The paper uses data collected from a nation-wide survey and shows an estimate of the Total Compliance Costs (Tcc) of VAT for the Republic of Mauritius for the year to 30 June 2001. Since there were no major changes in the VAT tax system from 2001 to 2010, the study used the consumer price index to estimate the Tcc for the tax year 2009/2010.

The paper also reveals the range (that is, the maximum and minimum amount) of Tcc at a 95 per cent confidence level for the Republic of Mauritius. It also calculates the net cash flow benefits of VAT and henceforth obtains the Net Compliance Cost (Ncc) for the same period. The study also formulates a multiple regression that can account for the factors that can influence compliance cost of VAT.

### 1.2 Implications of the research

Due to persistent budget deficits and fall in tax revenue, Mauritius introduced VAT as from 7 September 1998 in replacement of the Retail Sales Tax (RST), as governed by the *Value Added Tax Act 1998*. As firms grow, VAT is one of the areas where they must deal with government regulations. The time needed to comply with VAT varies considerably between developed and developing countries. It has been argued that regulatory requirements are burdensome and can sometimes be a constraint for mainly small and medium size firms. This paper contributes to the factors influencing

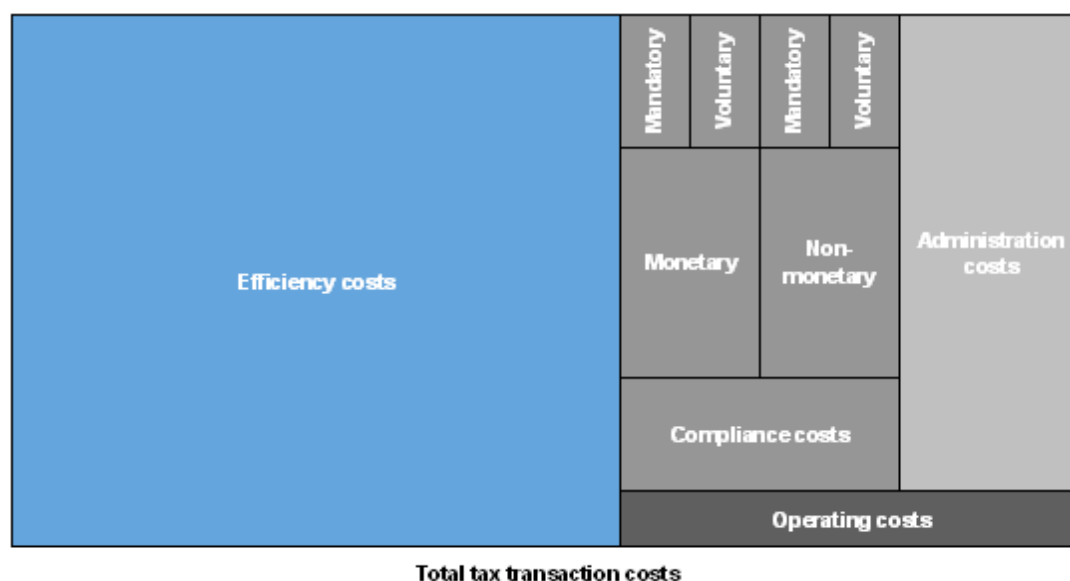
compliance costs of VAT for the Republic of Mauritius. What can be implicated from this paper though there may be various factors governing the compliance costs of VAT, the number of invoices handled by a business can be classified as the most significant factor. Besides, the size of the firm and the professionals are key determinants to the net compliance costs as the small firm had a 'disbenefit' to VAT. This is very important for policy makers as there are significant variations not only in size but type of business, therefore factors should be given different weights when designing policies for the different types of firm.

## 2. THEORETICAL CONCEPTS OF COMPLIANCE COSTS

The imposition of taxes is a necessity tool for government as it represents a major part of total revenue. The collection of taxes generates two broad types of social cost namely efficiency and operating costs (administrative plus compliance costs). Efficiency costs (also referred to as dead weight loss or excess burden), arise from tax-induced changes in relative prices, distorted consumer and producer choices, and can ultimately bring losses in overall output. Operating costs form a necessary component of raising tax revenue but the important point is to know the appropriate and acceptable level of costs. Operating costs are justifiable if the costs of raising the tax revenue (including the efficiency costs) are outweighed by the net benefits. Administrative costs are the costs borne by the tax authority to collect taxes and their other duties towards the taxpayers. Compliance costs are costs that are borne by taxpayers to abide by the tax authority. Compliance costs cover a range of both monetary and non-monetary cost. They include costs such as: acquiring the necessary and relevant knowledge of the tax system; compiling records; acquiring and maintaining the accounting tax systems and submitting of tax returns forms; evaluating the tax effectiveness of alternative transactions and methods in complying with law requirements; and collecting and remitting taxes to the tax authority. Compliance costs may also be mandatory or non-mandatory. Mandatory costs are those costs that taxpayers must incur to meet their statutory obligation such as reporting particular types of income or being able to substantiate deductions claimed. Voluntary costs are additional costs that the taxpayer may choose to incur to determine or minimise their tax liability by choosing alternative methods through tax planning. Administrative costs are the costs to the government of collecting taxes, and compliance costs are the value of resources expended by taxpayers in meeting their tax obligations. Figure 1 provides a schematic representation of the types of costs incurred in raising tax revenue.

Sandford (1995 Pp1) provides the definition of compliance costs, which is internationally accepted. Compliance costs are:

... costs incurred by taxpayers or third party, notably businesses, in meeting the requirements laid on them by the tax law and the revenue authority (excluding the payment of the tax itself and any distortion costs arising from it).

**Figure 1: A breakdown of tax transactions costs**

(Source: Oliver and Bartley, 2005)

Compliance costs might also be divided into money costs, time costs and 'psychological' costs. Money compliance costs include costs of employing additional staff in the tax department; fees paid to accountants for tax advice and incidental costs of postage, telephone, and travel to communicate with tax advisers or tax office, which are easily quantifiable. Time compliance costs are incurred where the tax legislation imposes duties such as the filling out of tax returns, additional ledger posting, and records to be made for tax purposes. However, the above two categories of compliance costs have been recently mitigated by the facility of taxpayers to fill in their return on-line. The most difficult costs to measure are the 'psychological' costs of complying with the legislation. Taxpayers suffer stress, anxiety and frustration in an attempt to abide by the tax legislation. However, no studies have managed to measure physiological costs successfully. Research done by Woellner et al in 2001 has used a combination of approaches to measure physiological costs of taxation. It includes the additional worry and anxiety to master and perform the complex duties imposed by the tax legislation efficiently under sanction of a legal penalty. Smith (1776 Pp 564) put it:

Though vexation is not strictly speaking expensive, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it.

Sandford (1995) and Pope (1990) refer to a concept of net compliance costs. This is defined as the gross compliance costs minus the value of any cash flow benefit or plus the value of any cash flow cost. Cash flow benefit arises when there is a time gap between the time tax liabilities are actually incurred and the tax payment. For example, any increase in compliance costs can be offset by additional interest earned (or cost borne if a reclaim) on the differences in the timing of VAT remittances to/from the Revenue Department (after 20 days of the return period). These are private benefits or costs, not to the society as a whole. While net compliance costs and cash flow benefits

are recognised to some degree internationally, to date *gross* compliance costs are the most widely used and accepted in measuring the burden of taxpayer.

It is important to note that there are conceptual problems when measuring compliance costs. Taxpayers require an efficient accounting system to provide information for a variety of purposes including the payment of tax, knowledge of the financial position of the business among others. Surveys of taxation compliance costs might include the cost of keeping a sound accounting system, which might have to be kept anyway. Therefore, tax compliance costs might be over or under estimated due to the difficulty in distinguishing between overlapping sources of costs.

Such methodological problems mean that, in practice, taxpayers who are required to provide information about compliance costs can have difficulty determining what the real tax compliance costs are. Where compliance costs can be measured accurately, it is important to note that they do vary according to the type of business, market characteristics, and management structure among other factors. Studies in compliance costs are likely to be somewhat imprecise due to these conceptual and methodological reasons, but still can prove to be an important tool for policy makers. There are many factors that can affect the measurement of compliance costs regardless of the actual costs in absolute value. In an Australian report published in 2006 (Chapter 13: p387), the factors that may affect the compliance costs composition are:

1. Differences in data quality arising from variations in response rates, validation procedures or questions;
2. Differences in the components of compliance costs;
3. Differences in tax structures including variations in tax reliefs and threshold;
4. The composition of the tax population including differences in the number of self-employed;
5. Differences in tax rates having a direct impact on compliance costs to revenue ratios;
6. Fluctuations in tax revenue collections over the business cycle;
7. Preference for tax expenditure as opposed to direct expenditure, as tax benefits provided within the tax system (through tax expenditure) increases compliance costs and decreases tax revenue.

Compliance costs are largely attributed by authors to the actual complexity of a tax system and, as these increase the effective rate of tax, they thereby reduce the efficiency and equity of any tax. There is currently a worldwide move towards simplification of tax systems. Simplification of tax system would eliminate or reduce the need for anti-avoidance sections in the tax legislature. This was cited in Ariff *et al* (1997 Pp 1255) as put forward by the Fiscal and Financial Policy Sub-Committee (1986):

A simple tax system is essential for the better understanding by individual and corporate taxpayers. A simple system will also mean fewer resources will be devoted to such socially unproductive activities as tax planning and tax litigation. Complexity imposes high compliance costs on the community and equally high costs on the tax administration.

So, the tax system imposes economic and social costs upon tax agents and companies. Policy makers need therefore to constantly and delicately balance the *four canons of taxation*, namely, *equity*, *certainty*, *convenience*, and *economy* as referred to by A. Smith (1776). These canons are sometimes in conflict, nevertheless policy makers need strike the right overall balance to ensure that fiscal policies whilst satisfying the overall goals of the country, do so without an unsustainable tax burden on the taxpayers.

Factors that influence the level of compliance costs include:

1. The extent to which tax collection procedures can be a routine (Oster & Lynn, 1980)
2. The size of the firm (Godwin, 1976)
3. The type of firm (Godwin, 1976; Sandford *et al.* 1979)
4. In the case of sales taxes, the ratio of the taxable turnover to gross sales and the size of the average transaction (Yocum, 1961).

### 3. VAT COMPLIANCE COSTS LITERATURE REVIEW

In the tax literature until the 1970s, research studies related to both administrative cost and tax compliance cost have been much neglected. Economic literature rightly recognised the impact and implication of tax administrative costs as pointed out by Sandford *et al.* (1981), whereby academic economists have shown little interest in compliance costs studies and tax policymakers do not even consider compliance costs in policy discussion.

It is worth noting that little work was carried out on compliance cost in the nineteenth century as the abolition of trade barriers and the overall decline in taxation as a percentage of GDP, caused such costs to diminish anyway. There are several reasons for this relative neglect:

1. Tax compliance costs have been thought to be insignificant
2. There is no proper and formal model for compliance costs minimisation
3. Tax compliance costs estimates typically involved painstaking fieldwork for collection of large amount of primary data not available from published sources.

As Professor Sandford, the guru in compliance costs studies pointed out, the worldwide introduction of VAT system has substantially contributed to the government interest in the compliance costs studies. VAT is one of the most prevalent revenue sources from indirect taxes for Mauritius and the estimation of its compliance costs are of utmost importance.

There has been a steady growth of international interest, particularly among OECD countries, in tax compliance costs, both by Governments and academic researchers. The bulk of the studies arose in the US and it was only through the research work of Sandford (1973) that the concept of compliance cost was first introduced in the UK. In recent years, new research has been conducted in the US, UK, Canada, Germany and

the Netherlands, while empirical studies have been undertaken for the first time in Ireland, Switzerland, Australia, Spain, Sweden and more recently in Singapore (Ariff, Loh, and Talib, 1995).

Research into compliance costs in CITs is a new phenomenon. The main reasons for the lack of interest in compliance costs in the CITs are shortages of experts — who may be overloaded with more, pressing issues such as no taxpayers' associations and no civil initiatives (Ott & Bajo, 2000). There are also several obstacles within the CITs to initiate such research — lack of interest, little cooperation of tax authorities and usually non-existent surveys data in CITs.

An article published by Evans (2003), revealed both the breadth and depth of research in the field of tax operating costs in the last twenty years after initial neglect. The impact and existence of tax operating costs is not a recent feature — it goes back to the eighteenth century, when the concept of taxpayers burden was first introduced by Adam Smith's (1776) four canons of a good tax practice (equity, certainty, convenience, and economy). This paper examined most of the major, and some minor, administrative and compliance costs studies published since 1980. This paper highlighted the increasing recognition of the impact of operating costs upon proposed changes in the tax law.

The principle aim is to go further and make available in a *single source* all of the most recent research in tax operating costs, thereby providing a guide to interested readers and prospective researchers to obtain an initial knowledge on studies carried out in this field. Sixty (60) studies were identified in the period since 1980 and split into four major regions, North America, Europe, Australasia/South-East Asia and the rest of the world.

Tran-Nam and Evans (2002, Pp 393) have noted that the early quantitative studies of tax compliance costs in the 1930s to 1960s took place in North America, a trend already highlighted earlier as the main area of initial studies. Researchers of diverse academic backgrounds, including management science, business studies, accounting and economics, undertook those studies. Various methodologies were used and most studies identified many of the features now regularly cropping up, such as, the regressive nature of compliance costs, and the potential trade-off between administrative and compliance costs.

The compliance costs studies laid more emphasis on quantitative techniques and used various methodologies to research into aspects of compliance cost. The methods used as stated in Evans (2003, Pp 70) ranges from questionnaire and/or mail surveys (Allers, 1994) to estimating/stimulating techniques (Thompson, 1984).

The main finding of these studies is that VAT compliance costs are very regressive and falls disproportionately on small firms. In particular there is a clear economy of scale, so that when the compliance costs as a percentage of turnover is measured, the effect of compliance costs for small firms is very large, yet the compliance costs of large firms are insignificant.

Studies prior to Hasseldine and Hansford (2002) have not taken the physiological variables into consideration, which is more visible for small business where it is very difficult to separate personal and business issues (Storey, 1994). A further neglected area is that UK small businesses have a large proportion of businessmen who belong



to the ethnic minority and English is not their first language. This may contribute to a greater difficulty in complying with the tax regulations. These two dummy variables have been studied by Hasseldine and Hansford (2002) and they found them to be quite significant. But the present paper does not take into account the physiological factor of compliance costs.

## 4. METHODOLOGY

### 4.1 Data and sample

The main sources of primary survey data were from lists of traders in the Yellow Pages telephone directory, as the official lists of registered traders were requested from the VAT Department but this data could not be forwarded due to the Data Protection Act. However, the official lists and collaboration of the VAT department was sought, and this is considered one of the major problems encountered by most CITs economies as tax authorities refuse to cooperate. In fact, tax administrations withheld their support in almost all the countries in which the earliest research projects into compliance costs were carried out, except in New Zealand and Sweden.

A stratified random sample was therefore chosen based on the different categories of firms as provided from the traders' lists in the Yellow Pages telephone directory. A large-scale mail survey (1,000 trades) was used, as it is a chance to obtain a large random sample that is most representative of the underlying population.

Consequently, the grossing up of the total figure was based on the mean compliance costs for each category of the sample multiplied by the total number of firms registered for VAT for the year 2001/2002 in each category — based on the classification used by the VAT department.

### 4.2 Regression model

Compliance costs were evaluated as far as possible in money terms for the fiscal year 2001/2002 and estimated the range of total compliance costs at a 95 per cent confidence level. Then, using the consumer price index, the study forecast the compliance costs for the year 2009/2010. The consumer price index was considered to be a good measure to predict future compliance costs as, since its introduction in 1998, only the VAT rate was changed from eight per cent in 1998 to 15 per cent now. So compliance costs will not drastically affected as within this time frame no major changes were made to the VAT system in Mauritius.

Comparison and analysis could be made with the tax revenue collected from VAT and Gross Domestic Product (GDP). Where data permits comparisons were made with the level of turnover, business sector, and number of employees.

The study then formulates regression models for each component that might influence compliance costs (turnover level, number of invoices, types of records, Net VAT paid). After analysing, which one had a significance influence on compliance costs, the best estimate for total compliance costs (Tcc) for the registered traders were then formulated using multiple regressions and the regression model was in the form of:

$$Tcc = b_0 + b_1 T + b_2 I + b_3 R + b_4 V + \dots + b_n X_n + \epsilon_i$$

Where,

$b_0$  - Constant value

$b_1$  - Standardised coefficient of T (turnover band)

$b_2$  - Standardised coefficient of I (no. of Sales invoices)

$b_3$  - Standardised coefficient of R (types of business records)

$b_4$  - Standardised coefficient of V (Net VAT paid)

$b_n$  - Standardised coefficient of the nth predictor ( $X_n$ )

$\epsilon_1$  - Error (difference between the predicted and observed value of Tcc)

To be able to obtain the **Total Compliance Costs (Tcc)** of VAT in the Republic of Mauritius, the compliance costs obtained from the questionnaire were grossed up according to the number of firms registered in each category from the official information obtained from the VAT department annual report. The raw data obtained from the questionnaire were then grossed up using the normal gross-up procedures for each category to be able to compute the total compliance costs for the Republic of Mauritius.

Thus, the survey helped in calculating the magnitude of **Tcc** in the Republic of Mauritius and also estimated the cash flow benefits arising due to the timing in remitting the VAT collected to the authority, to obtain the **Net Compliance Costs (Ncc)**. The total tax compliance estimated from the survey were then further analysed and an attempt made to show any correlation existing between the size of the business and its tax compliance costs. It also investigated Tcc per employee and highlighted any reasons for such a burden for VAT among the firms in Mauritius. The survey also attempted to find out whether tax compliance costs of VAT had a relationship to the size of the business based on the turnover band or the number of employees.

Finally, the study recommended certain useful measures in order to reduce the compliance costs and thereby improving the efficiency of VAT collection as a source of revenue for the government.

## 5. FINDINGS

### 5.1 Magnitude of the gross and net compliance costs

For the analysis, the firms have been classified based on the turnover as follows:

Size	Turnover band
Very Small	Under MUR 15 million (inclusive)
Small	Between MUR 15 million to MUR 40 million (inclusive)
Medium	Between MUR 40 million to MUR 125 million (inclusive)
Large	Above MUR 125 million

These distinct categories were chosen as firms were classified according to the turnover level, and as it is also the criterion used by the VAT department for registration purposes and determination of the return period. Before trying to seek for any causes or characteristics that resulted upon the imposition of VAT by the government, the composition and size of compliance costs were calculated from the data collected.

The compliance costs for the fiscal year to 2001/2002 can be summarised in Table 1 below, indicating the **Tcc** broken down into **Internal Compliance Costs (Intcc**, incurred by the within the firms), **External Compliance Costs (Extcc**, incurred by tax agency) and also **Ncc**. The study also calculates the range of total compliance costs at a 95 per cent confidence level. The compliance costs are obtained based on data collected from the questionnaire and as traders in the pilot study face difficulties in recalling the commencement costs, this present study does not therefore emphasise the classification between the commencement costs and ongoing routine costs as in the Sandford (1979) study carried out in the UK. Note that this study also excludes the psychological costs such as the worry caused to traders due to the VAT legislation and any social costs such as the loss caused to the community when firms restrict their range of products to simplify the tax recording procedures, hence leading to a reduction in the compliance costs. Therefore it can be deduced that although these costs are very important, they are however not easily measurable.

The Ncc can be ascertained by deducting cash flow benefits from the total measurable compliance costs (Tcc). The benefits to registered traders can be of two kinds: Cash benefits and managerial benefits. Cash benefits are monies held by traders, owed to (or from) the tax authority. Registered payment traders, as tax collectors, benefit from holding the net VAT from the day collected from customers up to one month after the end of the return period (quarterly or monthly) where it is remitted to the tax authority. Repayment traders, on the other hand, face disbenefit through input tax suffered but not yet claim from the tax authority. Managerial benefits are the VAT component of any net credit arising from commercial transactions and VAT operations such as better record keeping. It may therefore be argued that the traders do enjoy a 'net cash flow benefit' over that period (if they are net payers to the revenue authority). Whilst reasonable values can be attributed to cash benefits, there is a strong case for not attempting to put monetary value to managerial benefits. It can be regarded, as unmeasurable benefits similar to the psychological costs that were also unmeasurable. The value of the cash flow benefit can be considered as equal to either the interest they could gain by lending the money or alternatively (for traders in overdraft) the cost of borrowing the equivalent amount from a bank or other financial institution. This cash flow can easily help the traders to reduce their overdraft facilities or other borrowing especially for those who collect large amounts of VAT during the return period.

The addition of the total for each category of firms, as shown in Table 1, gives the total 'measurable' compliance costs of VAT for the Republic of Mauritius at MUR 411.8 million, representing 5.8 per cent of total tax revenue from VAT for the period 2001/2002 and 0.3 per cent of GDP at market prices for the same period. From the study, it is also revealed that at a 95 per cent confidence level, the Tcc are in the range of MUR 336.7 million and MUR 486.7 million for the period 2001/2002. In addition, by readjusting the total compliance costs after the effect of inflation, the total compliance costs of VAT are estimated at MUR 489.2 million for the year 2009/2010.

**Table 1 Total and net compliance costs for the year 2001/2002**

Traders Category	Intcc	Extcc	Total Compliance Costs (Tcc)			Net Benefits	Ncc
			Lower Limit*	Upper Limit*			
	Rs' m	Rs' m	Rs' m	Rs' m	Rs' m	Rs ' m	Rs' m
Very Small	23.5	10.1	25.6	41.7	33.6	-(0.2)	33.8
Small	96.1	40.0	121.0	151.2	136.1	4.2	131.9
Medium	92.7	57.2	119.2	180.5	149.9	7.1	142.8
Large	66.0	26.2	70.9	113.4	92.2	9.8	82.4
Total	278.3	133.5	336.7	486.8	411.8	20.9	390.9

\* - Value of Tcc at 95% confidence level

It can also be estimated that at a 95 per cent confidence level, the total compliance costs of VAT are in the range of MUR 400 million and MUR 578.2 million for the period 2009/2010 (Base year 2001/2002 = 100 and CPI for 2009/2010 = 118.8).

From the data published in the government's Annual Report (Revenue Authority, 2002), administrative costs for VAT amounted to MUR 32.9 million, representing only 0.47 per cent of total VAT receipts for the year 2001/2002 as compared to compliance cost of 5.8 per cent of VAT revenue. Previous studies on administrative costs have shown that these costs are both absolutely and relatively less burdensome than the compliance cost. They also highlight that administrative costs rarely exceed one per cent revenue yield, more usually well below one per cent as is the case for Mauritius with only 0.47 per cent. Therefore, total operating costs of VAT for the Republic of Mauritius are MUR 444.7 million, representing 6.3 per cent of the total revenue yield from VAT. This may be explained by the introduction of self-computation assessment, where the cost of operating the VAT was shifted from the tax administrators to the taxpayers, thus causing a high compliance cost, representing 92.6 per cent of total operating costs.

The Ncc are MUR 390.9 million and the effect of net cash flow benefits over the size of firms is significant when it reaches the highest level of firms. As for 'very small' firms instead of enjoying a benefit they are faced with disbenefit as they normally register voluntary for VAT and have suffered input tax and expect to have a repayment, which takes longer (45 days) for the government to repay. Thus, taking payment and repayment traders together, the net cash flow benefits are MUR 20.9 million, thus the VAT department is indeed making a considerable net 'loan' to the business community. The cash flow benefits however represent only 5.1 per cent of total compliance costs and as such are quite insignificant.

The internal compliance costs (Intcc) are MUR 278.3 million and External compliance costs (Extcc) are MUR 133.5 million representing 32.4 per cent of the Tcc, which is

relatively high compared to say only five per cent in Australia as revealed by the ATO study in 1998. This may be explained by traders preferring to transfer their burden of calculating their tax to the accounting firm acting as tax agent rather than having the VAT return in-house. Besides this, the total compliance costs as a percentage of total revenue collected from VAT is around 5.3 per cent, which is relatively higher than that of the UK at only 2.8 per cent (Sandford *et al.*, 1981) but much lower than that of Australia (which had WST in 1998) at 12.1 per cent (ATO, 1998). The latter has revealed to be relatively higher due to the complexity existing in Australian tax law.

## 5.2 Regressivity of compliance costs

One of the most common aspects of total compliance costs in all research studies has been without doubt the unbalanced distribution of compliance costs among different traders. It has often been revealed that 'large' firms bear relatively less total compliance costs as a proportion of total turnover size than 'very small' firms. The economies of scale can be easily observed by expressing Tcc as a percentage of total turnovers (TT). Sandford *et al* (1981) found that small firms (those with turnover less than £ 50,000 per annum) could incur as much as 1.17 per cent of their TT as CC, while very large firms (those with turnover above £ 1 million) incurred only 0.04 per cent. From the present study the pattern of total compliance costs as a proportion of total turnover are as shown in Table 2.

**Table 2: Total compliance cost (Tcc) as a % of total turnover (TT)**

Category of traders	No. of Cases	Total Turnover (TT)	Total Compliance Costs (Tcc)	Total cc as % of TT	External cc as % of TT	Internal cc as % of TT
		Mean Rs ' m	Mean Rs	%	%	%
Very Small	33	13.2	61,173	0.46	0.32	0.14
Small	53	33.25	70,159	0.21	0.15	0.06
Medium	48	109.5	90,213	0.08	0.05	0.03
Large	32	138.2	102,749	0.07	0.06	0.02
Overall	166	58.6	83,115	0.14	0.04	0.10

Table 2, in which Tcc is expressed as a percentage of TT, reveals the full extent of the regressive nature of compliance costs. It can be noted that although in absolute terms the mean compliance costs rise fairly consistently with the size of business, the rise is much less than proportionate. Expressed as a percentage of TT, the 'very small' traders (those with turnover less than MUR 15 million) costs are estimated proportionately at more than three times than those of 'large' traders (those with turnover above MUR 125 million). Thus, the Tcc as a percentage of TT shows that 'very small' and 'small' traders are 0.46 per cent and 0.21 per cent respectively compared to only 0.07 per cent for 'large' traders. The CC as a percentage of TT for all firms merged (Overall) is 0.14 per cent, which is very much lower than the percentage of the 'very small' and 'small' traders but higher than the 'medium' and 'large' traders with 0.08 per cent and 0.07 per cent respectively. This demonstrates

that the 'very small' and 'small' traders bear a relatively heavier burden to VAT and also reveals that compliance costs to VAT is regressive in relation to size of trader.

Furthermore, with the breakdown for internal compliance costs, expressed as a percentage of total turnover, it shows that only for 'very small' firms with 0.14 per cent it is above the overall of 0.10 per cent, compared to only 0.02 per cent for 'large firms'. This indicates that 'very small' firms bear relatively more costs than 'large' firms do, as there is a minimum internal compliance cost (fixed costs) that needs to be borne by all firms and thus the large firms are able to enjoy economies of scale. As for the external compliance costs, it is 0.32 per cent for 'very small' firms as opposed to only 0.06 per cent for 'large' firms, revealing that the costs of an accountant press more heavily on the firms small in size. However, it is worth noting that the external costs as a percentage of compliance costs for 'medium' firms (0.05 per cent) are lower than that of the 'large' firms. This may be caused by the competitive market pricing prevailing among accounting firms and there is a 'limit' to the price that could be charged to 'large' firms.

Clearly then, total compliance costs, as a proportion of total turnover is highly regressive for traders in Mauritius. These results show clearly that the burden of compliance costs is so much less for large firms than for small ones. Traditionally, economies of scale have rested on the scope offered for specialisation that is expected to play its part in VAT compliance research work. The 'large' firms have staff working full time, and partly qualified staff under the supervision of the financial controller does much of the book-keeping and accounting activities including the VAT related work. As for the 'very small' firms, the owners themselves have to do all the record-keeping related to VAT along with everything else and often lack the relevant skills and practice and thus, depend heavily on an external accountant for filling their VAT return, leading to heavier costs being incurred.

The high compliance costs for 'very small' and 'small' firms is also a factor of the number of invoices to be dealt, which do not rise in the same proportion as the turnover level, due to small and petty sales items. As for 'Large' traders, they usually buy and sell in bulk and often the numbers of sales invoices cost proportionately less to handle. Thus, compliance cost is dependent on the number of invoices being handled and the size of each transaction as stated in the German study by Neihus (1969). However, there is an element of fixed costs involved in the setting up and running of the VAT system, namely that it is the same across all registered firms with a lower burden for the larger firms due to economies of scale. Further, large firms use sophisticated and non-manual means to deal with VAT more efficiently and effectively, as the accounting system installed can deal with most VAT work with very little additional cost.

Another way of measuring regressivity is by the use of single index, the Gini-coefficient. The Gini-coefficient is a measure statistical dispersion most prominently used as a measure of inequality of income distribution. It can be used to compare the compliance costs distributions across the different turnover levels. The coefficient lies strictly between the values of zero (0) and one (1). The higher is the Gini-coefficient, the greater the deviation from perfect equality. Therefore the more unequal the actual level of turnover against compliance costs. In this context, 'zero' corresponds to the perfect income equality (that is compliance costs vary with the level of turnover, in other words, no concentration), and 'one' corresponds to perfect income inequality (that is compliance costs are more emphasised in one category of traders, the case of

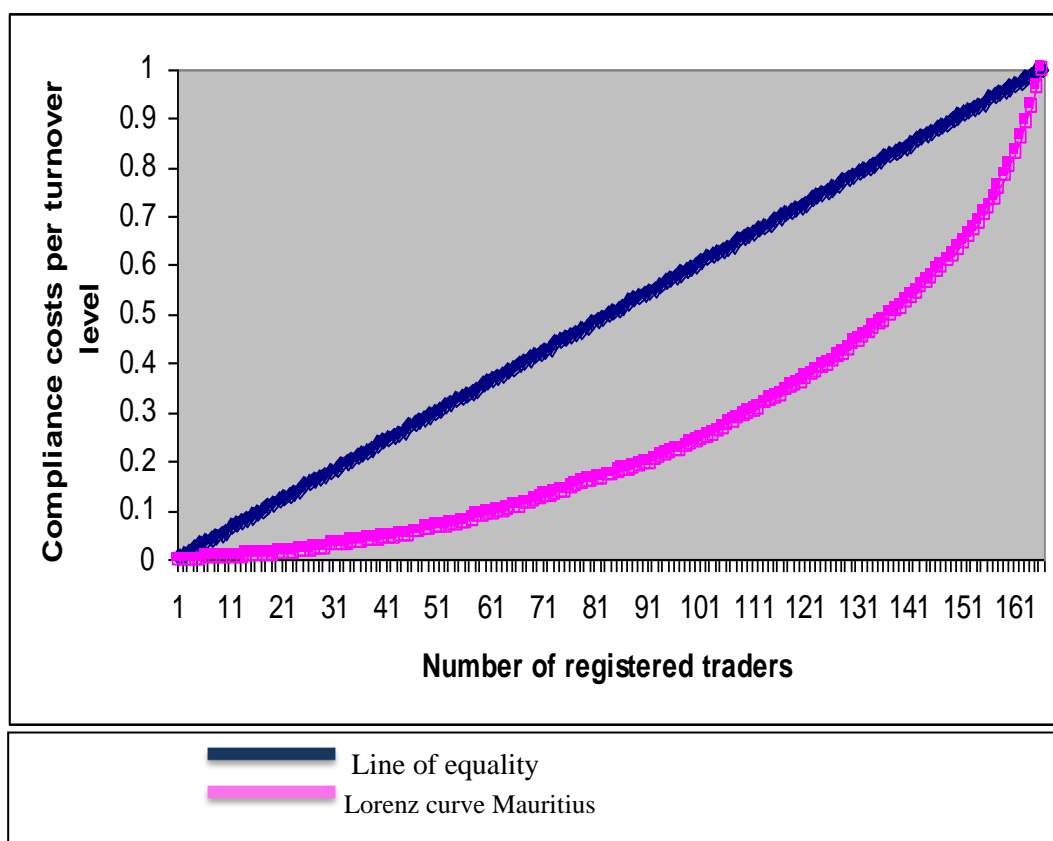
total concentration). The Gini-coefficient tells us how widely the total compliance costs 'altitude' varies with the turnover level in a given country.

From the responses, the main variables used are compliance costs per turnover level ( $Y_d$ ) and the number of registered traders for VAT ( $n$ ). The Gini-coefficient is calculated using the formula below:

$$\frac{\sum_{i=1}^n (2i-1)Y_{di}}{n \sum_{i=1}^n Y_{di}}$$

The Gini-coefficient amounts to 0.49 and the curve in Figure 2 of cumulative point compliance costs per turnover level against the cumulative number of registered traders' indicating that there exists an element of inequality between the compliance costs and the category of traders. One hundred and one out of 166 traders, representing 61 per cent of total traders hold a compliance cost per turnover of approximately 20 percent only (0.2), that is, compliance costs per turnover is not concentrated in one category of turnover. If compliance costs per turnover level were the same for all categories of traders, representing total equality, the compliance cost curve would have been the straight line as shown in the graph.

**Figure 2: Compliance costs per turnover level against number of registered traders**



### 5.3 Number of employees as a measure of regressivity

Normally, the number of employees in a firm helps to define the nature and size of a firm. An alternative way of looking at regressivity is to examine the compliance costs per employee. The Tcc per employee helps to indicate how much each employee is contributing towards the costs involved in abiding to VAT legislation. The total compliance cost per number of employees decreases with the size of the business. The mean number of employees for 'very small' is eleven (11) times more than that of 'large' firms, rising from a mean employee of 23 for 'very small' firms to mean employee of 257 for 'large' ones, as clearly shown in Table 3.

**Table 3: Compliance Costs per Employee**

Category of firms	No. of employees	TCC per employee
	Mean	MUR
Very Small	23	3,672
Small	58	1,830
Medium	78	1,505
Large	257	1,120
Overall	95	1,965

In a study done in Sweden (Huges, 2006), it was observed that the compliance costs per employee for small firms with one to four (1–4) employees were 35 times higher than that of big businesses with fifty to four hundred and ninety-nine (50–499) employees. From the present study, the compliance cost per employee is MUR 3,672 for 'very small' firms but only MUR 1,120 for 'large' firms, and relatively higher than the overall average for all categories of firms combined at only MUR 1,965. Therefore, both the compliance cost per employee and the total compliance costs found above are regressive as for 'large' firms the compliance costs being widely spread over a higher number of employees proved more cost effective.

**Table 4: Number of employees as an indicator for Tcc**

R	Model	R square	t-test
0.169	1	0.029	2.138

Further, Model 1 (Table 4) tries to highlight the existence of any relationship between total compliance costs and the number of employees. The Pearson correlation R is only 0.169 indicating a low positive correlation but the correlation is statistically significant at 0.05 levels (two-tailed test). From Table 4,  $R^2 = 0.029$ , indicating that the number of employees contribute to an insignificant 2.9 per cent of variations in total compliance costs.

This seems to be valid and reasonable as compliance costs for VAT has no bearing on the number of employees compared to PAYE which varies according to the number of



employees in the payroll system. In a study done by Collard et al. (1999) it was found that compliance cost of PAYE was highly correlated to the number of employees ( $R=0.94$ ). This can be expected as number of employees working in a firm has a direct impact on the tax withheld by their employer on their respective earnings, but it has no bearing on the VAT payable, which is a tax charged on taxable supply.

#### 5.4 Indicators of total compliance costs

A multiple regression was run using the hierarchical regression model. The forward, backward and stepwise methods rely on the computer selecting the variables based on mathematical criteria. Many writers and social science researchers argue that this takes many methodological decisions out of the hand of the researcher, as decisions of which variables should be included will be based upon slight differences in their semi-partial correlations. However, these slight statistical differences may contrast dramatically with the theoretical importance of a predictor in the model. For this reason stepwise method is more suitable for explanatory model.

Since there is a sound theoretical literature available on compliance costs, then the hierarchical method is a better model for predictor of the total compliance costs. In this model, predictors are selected based on past research (turnover, invoices and method of recording) and additional predictors available are included in the model in order of importance. Therefore, all potential factors that might contribute to the Total Compliance Costs (Tcc) are included as the dependent variables. Different models are generated indicating the relationship between Tcc and number of invoices, turnover band and the methods of recording for VAT as shown in the Table of Coefficients, Table 5.

From the correlation matrix, the Pearson correlation coefficient ( $R$ ) between each pair of variables can be seen (for example, it can be seen that turnover band and sales invoices have a positive correlation with Tcc,  $R = 0.420$  and  $R = 0.423$  respectively, while that of the use of accountant with Tcc has a low positive relationship,  $R = 0.035$ ). Secondly the one-tailed statistically significance of each correlation is displayed (for example, the correlation for Tcc with turnover band, number of invoices, net VAT paid and the methods of recording VAT are statistically significant as  $P < 0.01$ . however, the use of accountant is not significant). The correlation matrix is useful for getting an idea of the relationships between predictors and the outcome, as a preliminary look for multicollinearity. Despite the significance of these correlations, there are no substantial correlations ( $R > 0.8$ ), there is therefore no collinearity between the predictors.

From the model summary (Table 5), Model 1 reveals that 'sales invoices', 'VAT records' and 'turnover band' account for 23.7 per cent ( $R^2 = 0.237$ ) of the variation in the total compliance costs. However, when another predictor NET VAT Paid (NETVATPD) is included to make Model 2, the  $R^2$  value is increased by 0.017 only, explaining that NET VAT Paid accounts for an additional of 1.7 per cent only. As for Model 3, inclusion of the service of an accountant (ACCTANT) contributes for an additional 0.5 per cent of the variations of total compliance costs.

**Table 5: Coefficients of the multiple regressions**

	Model	unstandardised coefficients		standardised coefficients	t	Sig
		B	Std error	Beta		
1	(constant)	-11234.2	20515		-0.548	0.585
	TOVER Turnover band	11699.853	4219.991	0.252	2.772	0.006
	RECORDS VAT records	16881.41	7772.738	0.163	2.172	0.031
	INVOICES sales invoices	4997.734	2506.66	0.191	1.994	0.048
2	(constant)	-5877.429	20527.61		-0.286	0.775
	TOVER Turnover band	11284.436	4189.777	0.243	2.693	0.008
	RECORDS VAT records	16244.947	7713.991	0.157	2.106	0.037
	INVOICES sales invoices	3813.527	2559.128	0.146	1.490	0.138
	NET VAT Paid	2733E03	0.001	0.143	1.943	0.054
3	(constant)	-12729.1	21579.81		-0.59	0.556
	TOVER Turnover band	10886.786	4206.881	0.234	2.588	0.011
	RECORDS VAT records	15974.54	7717.135	0.155	2.070	0.040
	INVOICES sales invoices	4336.713	2608.839	0.166	1.662	0.098
	NET VAT Paid	2595E13	0.001	0.137	1.860	0.065
	ACCTANT Accountant	3884.584	3780.013	0.071	1.028	0.306
a Dependent variable CC Total Compliance costs						

From Model 1, the adjusted  $R^2$  (0.223) is very close to the value of  $R^2$  (0.237), in fact the difference is only 0.014, about 1.4 per cent. This shrinkage means that if Model 1 is derived from the population rather than from the sample, it will account for approximately 1.4 per cent less variance in the outcome. The change in statistics (F-ratio) for Model 2 and Model 3 are 3.774 and 1.056 respectively, but it is not significant as  $P > 0.01$ , indicating that there is no major difference made by adding the new predictors to the Model 1. Finally, the Durbin-Watson statistics test whether there is any correlation between the residuals and from the model; DW is 1.940, close to two, indicating that there is no autocorrelation.

Further, the ANOVA also tells us whether the model is a significant fit of the data overall. The value of F is greater than 1 for all the three models (relatively higher for Model 1,  $F = 16.773$ ) and the probability is less than 0.001, this indicates that Model 1 significantly improves our ability to predict the outcome variable (total compliance costs). However, that the other two models (2 and 3) with additional predictors do not improve Model 1 significantly as F ratios are relatively lower. Therefore, Model 1 is a better predictor for the outcome of the variable. So, methods of VAT records, number

of VAT invoices, and turnover band are better predictors for the value of the total compliance costs.

Therefore, the multiple regression equation (Model 1) predicting the total compliance costs can be defined as follows:

$$Tcc = -11,234 + 4,998 \text{ } \acute{\imath} + 16,881 \text{ } \acute{r} + 11,700 \text{ } \acute{s}$$

Where,

$\acute{\imath}$  - Number of invoices

$\acute{r}$  - Methods of recording VAT

$\acute{s}$  - Sales band (level of turnover)

From Model 1 in Table 5 above, the *t*-statistics indicates whether the *b*- value is significantly different from zero, as *t* indicates the slope of the line. From the magnitude of the *t*-statistics (approximately 2), we can predict that turnover band, number of invoices and the methods of recording for VAT have a similar impact on the total compliance costs and the *b*-value is significant as  $P < 0.05$ . Besides, the standardised beta value ( $\beta$ ) reveals the number of standard deviations that the outcome changes as a result of one unit change in the predictor. These values can be interpreted as follows:

**Invoices:** ( $\beta = 0.191$ ): This value indicates that as the number of invoices increase by one standard deviation (1,669), total compliance costs increase by MUR 8,320 ( $0.191 \times 43,559$ ). This interpretation is true only if the effects of sales band and methods of records for VAT are held constant.

**Turnover Band:** ( $\beta = 0.252$ ): This value indicates that as the level of turnover increases by one standard deviation (937,000), total compliance costs increase by MUR 10,978 ( $0.252 \times 43,559$ ). This holds true only if the effects of invoices and methods of recording VAT are held constant.

**Records:** ( $\beta = 0.163$ ): This indicates that as the methods of recording for VAT rated one standard deviation higher (0.421), the total compliance costs increase by MUR 7,100 ( $0.163 \times 43,559$ ). This holds true only if the effects of invoices and level of turnover are held constant.

Consequently, it can be concluded that the estimation of the gross compliance costs for the Republic of Mauritius is MUR 411.8 million and the net compliance costs is MUR 390.9 million. Note that the 'very small' traders faced a disbenefit to VAT due to the lengthy period between submission of return and repayment of VAT. This study also confirms the unbalanced distribution of compliance costs among registered traders as the compliance costs as a percentage of turnover level decreases. Besides, the dependent variables in Model 1 (number of invoices, turnover band and methods of recording) are a good predictor for the variations of total compliance costs. Therefore, this study explains 23.7 per cent of the variations in compliance costs, indicating that there may be other reasons unknown to this research influencing the total compliance costs or that the total compliance costs of VAT in Mauritius has a high element of fixed costs (minimum compliance costs) that do not vary with any indicators mentioned above.

Comparisons of compliance costs are difficult to conduct and need to be treated with caution, particularly if the case is for comparison involving multiple countries over long periods. Sandford (1995, p405) noted that international comparisons of operating costs (compliance costs and administrative costs) are more likely to mislead than enlighten. Table 6 below shows a comparative summary of the total compliance costs from some of the major studies carried out in different countries. The varied methodologies (mainly telephone, questionnaire surveys, and case study) and particularly the different treatment of time costs can render an effective comparison and inferences extremely difficult. A comparison of the total compliance costs in absolute terms cannot be possible due often to the differences in exchange rates and inflation rates as the studies were carried out at different periods of time.

However, the percentage of compliance costs to VAT revenue ranges from two per cent to 11 per cent and Mauritius was six per cent, which falls within that comparable proportion. As for the response rate, the rate of Mauritius being 20 per cent can be considered relatively low but it does represent four per cent of the total population — a good representation of the population for a nation-wide study.

**Table 6: Comparative table of the major studies of VAT compliance costs**

Country	Author (s)	Year Study	Tcc	CC as % VAT Revenue	Response Rate (%)
UK	Sandford et al	1977-78	£ 392m	11	31
	Sandford et al	1986-87	£ 791m	3.69	24
Australia	Pope (WST)	1993	A\$ 201m (Ncc)	2.1	24
	Evans et al (WST)	1997	A\$ 4,647m	9.3	36.4
Sweden	Huges	2006	SEK 1,900 m	3	n/a
Croatia	Blazic	2001	HRK 968.1 m	6	0.57% pop
Netherlands	Allers	1994	Gld 2,100	6	20
<b>Mauritius</b>		<b>2001-02</b>	<b>Rs 411.8m</b>	<b>5.80%</b>	<b>20.3</b>

The massive growth of the compliance costs literature reflects the fact that these 'hidden costs' of taxation are now a matter of considerable public concern, particularly in the business community. But government, revenue authorities, legislators, and taxpayers generally have become increasingly aware of the role and impact of compliance costs (administrative costs to a lesser extent) and there is a growing demand that compliance costs must be taken into account in the tax law design process.

In Klun 2004, as cited by Sandford (1995) states that the OECD research work into how the evaluation of compliance costs influenced tax policy concluded that only four OECD countries had a strong influence; the evaluation was used periodically by nine countries and the remaining had a minimal influence. Despite the long democratic tradition in these countries, compliance costs are often neglected in determining tax policy. In view of reducing the compliance costs burdens, the government of

Mauritius should assess the likely change in compliance costs whenever a tax reform is undertaken, note that no major tax reform was made to the VAT system since its introduction. The Mauritian government should also try to measure the size and composition of compliance costs and identify the characteristics that affect these costs. Thus, upon a change or an introduction of a new tax, care should be taken so that small firms or taxpayers not to bear an undue burden of tax. To encourage compliance the ATO publishes an annual compliance program detailing the focus risk areas as part of evaluation of an annual 'health of the system assessment' process. The HM Revenue and Customs Department in the UK normally measures the impact of compliance costs upon a change in the tax system and the analysis is published in a final Regulatory Impact assessment (RIA) when the associated legislation is laid before parliament. This assessment of the compliance costs impact assists in future policy development and evaluation work and helps the Government to improve tax compliance, face less resistance to change, thus increasing tax revenue.

Studies into compliance costs have nowadays created substantial public interest in particular concerning small business. Governments of various countries have begun to introduce measures to monitor compliance costs, limit incremental compliance costs, and where possible reduce compliance costs. The following are initiatives adopted by governments and it is high time for the Mauritian Government to take some of those initiatives to combat compliance costs:

1. Requirements that all new tax legislations be supported with a form of tax compliance costs impact statement;
2. Introduction of programmes and guidelines to improve the clarity of tax legislation;
3. Establishment of specific government bodies or task force in advising governments on the effectiveness of regulatory measures and identifying ways of minimising regulatory compliance;
4. Introduction of public consultation guidelines on the development and implementation of new policies;
5. Establishment (or development) of models or methods to measure the burden of new law or regulations, and
6. Introduction of specific compliance cost reductions targets.

## 6. CONCLUSIONS

This study on compliance costs at a national level is the first carried out in this field in Mauritius. Given the circumstances, research in tax is very difficult, as the researchers do not receive much support from the government or the tax authority. This study is the first attempt in calculating the magnitude of compliance costs for VAT in Mauritius and identification of a relationship of the compliance costs with the size of firms, number of invoices, and number of employees among other factors. However, the present study did face major difficulties, as taxpayers in CITs were not accustomed to questionnaires and were not comfortable responding to questions on income, turnover, and attitudes' to tax as these are considered to be very confidential matters. Though the purpose and objectives of the study were clearly spelt out in the covering

letter, the study faced a low response rate due to no collaboration from the tax administrators as was the case for most studies in developed countries.

Any research that assesses the taxpayers' point of view is important evidence for policymakers. Prospects exist for similar studies to be carried out on other taxes such as PAYE and company tax and also making comparison with other neighbouring developing and developed countries. It can be concluded that compliance costs are an important feature for any government as high tax compliance costs can lead to avoidance or even evasion of tax causing a reduction in the expected tax revenue for the government. This research did not attempt to make suggestions as to how compliance costs should or might be reduced or redistributed. The tasks of reducing or redistributing compliance costs is, perhaps one of the biggest challenges facing tax policy makers and administration in Mauritius and overseas. The analysis and recommendations reached from this survey may help tax administrators to improve the VAT tax system making it more efficient and less troublesome for the registered traders. However, the primary concern should now be how and where tax reform may be carried out leading towards minimisation of the compliance costs consistent with the objectives of tax legislation and revenue generation for the government.

This paper has estimated the gross compliance costs of VAT at MUR 411.8 million and net compliance costs are MUR 390.9 million. The analysis of the study has been able to show only 23.7 per cent of the variations of compliance costs and has revealed that there is a huge element of fixed cost. This paper also draws an insight into the main factors influencing compliance costs for the Republic of Mauritius. The number of invoices, turnover band and methods of keeping records are revealed as the most significant factors that affect the compliance costs of VAT.

The major limitation of such a large-scale postal questionnaire survey is that the researcher is often criticised for the non-representativeness of the respondents to the taxpaying population (that is, low response rate). Besides this, large proportions in the sample were not willing to complete the questionnaire, as this was the first such survey on compliance costs done in Mauritius and thus the respondents were not familiar with the concept. However, since such a low response rate was expected for research on taxation affairs, a larger sample thus was chosen (1,000) to mitigate this and efforts were made to obtain an adequate number of responses sufficient for analysis to be statistically representative of the population.

Another limitation of the study was with the follow-up interviews, where many difficulties were faced to obtain an appointment with the professionals and lawyers who were always busy and unwilling to provide enough time for a well-structured interview for the much richer qualitative information to be collected.

A more practical limitation of the survey method is that it is costly and time-consuming, especially as reminders, chasing and sorting out of responses were required. The present study was pioneering research work carried out by a single researcher. In future for better response rates, such types of research needs to be carried out by a team of researchers with the active support of the tax authorities. Research of this calibre needs a good organisation and management of the mailing system, which sometimes can prove difficult.

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