Improving Tax Compliance in the Cash Economy – A Developed Economy Perspective on Informal Sector Issue

Purpose: Information
Submitted by: Australia
INTRODUCTION

This presentation and handout was designed to share Australia’s experience in trying to improve participation and compliance with our tax system. The challenges of the informal economy, or the cash economy, are something all jurisdictions experience, and it is difficult to address and demonstrate that we are making improvements. This presentation will focus on the cash economy journey in Australia, including what has worked recently, and what the Australian Taxation Office plans to focus on in the future.

A BRIEF OVERVIEW OF THE AUSTRALIAN TAX SYSTEM

Since 1986-87, Australia has operated a system of self-assessment of income tax – where we rely on taxpayers assessing their liability under the law and paying the correct amount of tax. This system of self-assessment has inherent risks, which are managed by balancing our resources and structuring ourselves accordingly to ensure that people meet their obligations.

Self-assessment also means a tax system based on our Taxpayer’s Charter, where we are open and fair in our treatment of people, within the framework set by the law. It sets out our commitment to inform people of their rights, obligations and entitlements, and directs the way we behave towards the community and sets out what the community can expect from us. This relationship has a starting point of mutual trust and respect.

We manage revenue through a range of collection systems, including income tax, goods and services tax (GST) – collected by the Australian Government on behalf of state and territory governments – superannuation and excise. We also administer a range of benefits and refunds, including the baby bonus, income tax and GST refunds, excise grants, family tax benefits, and superannuation guarantees.

- Income tax is the largest of the revenue systems that we administer. It includes personal tax, company tax, capital gains tax and taxation of superannuation funds (including the superannuation contributions surcharge). Income tax is estimated to account for around 70% of the total tax revenue.
- We play a significant role in administering the superannuation system, which now has around $600 billion in superannuation fund assets under management. Our role includes administering the superannuation guarantee and regulating self managed superannuation funds. Excise duty is levied on the domestic production of alcohol, tobacco and petroleum products, generally based on their volume. This excise system also delivers fuel grants and...
administers the product stewardship for oil program. Excise accounts for around 10% of tax revenue\(^1\).

In the year 2000 A New Tax System (ANTS) was introduced that included a goods and services tax (GST), like value added tax (VAT) in other jurisdictions. GST is a broad-based tax of 10% on the supply of most goods and services. There are 2.4 million businesses registered for GST, including charities and other non-profit organisations\(^2\).

The goal of the Tax Office is to work with the community in the fair administration and effective management of the tax system to add value to our nation. Our business intent is to optimise voluntary compliance and make payments under the law in a way that builds community confidence\(^3\).

We collected more than $A37.4 billion in GST for state and territory governments\(^4\). At June 30 we employed 21,511 full-time equivalent employees in offices all around Australia, with GST full time equivalent employees being 2,840\(^5\).

**Our cash economy journey over the past ten years**

Since the introduction of A New Tax System (ANTS) cash economy compliance activities were managed from the perspective of an industry focus. This approach focused on industries that historically have presented opportunities to engage in high volume cash transactions. Integrity measures introduced as part of ANTS in the year 2000 (like Australian Business Number and GST registrations) have led to a high degree of voluntary compliance in the business to business transactions. Businesses tend not to deal with businesses who do not have an Australian Business Number. However, both the ANAO\(^6\) and the CETF\(^7\) recommended that the Tax Office needs to better address transactions in the business to consumer space.

In 2006-07 we revised our definition of cash economy that places the focus on non-reporting behaviour. This recent change in definition has refined the scope of cash economy activity and focuses us on the risk of non-reporting of cash transactions. Rather than only identifying the industries that present cash risks, we are putting more emphasis on behaviours across industries and also examining particular trades and activities within industry groups where appropriate. The main objective of cash economy compliance activity is still to maximise participation in the system.

**Small to Medium Enterprises (SMEs) and an overview of cash economy**

We tailor our compliance approaches to suit six market segments to better differentiate our responses according to the level of risk presented by the characteristics and circumstances of each segment. These segments are:

- Individuals
- Micro Business (annual turnover $0 - $2 million)

\(^1\) Compliance Program 2006-07, Australian Taxation Office, pg2.
\(^2\) ibid, pg2.
\(^3\) Strategic Statement 2006-10, Australian Taxation Office.
\(^5\) ibid, pg iv and pg 290.
\(^6\) Australian National Audit Office
\(^7\) Cash Economy Task Force
Small to Medium Enterprises (annual turnover $2 million - $100 million)
Large Business (annual turnover larger than $100 million)
Non-profit organisations
Government organisations

This emphasises the point that while each jurisdiction may have a slightly different definition or demarcation of Micro and SMEs, we share a lot of the cash economy issues.

There are around 2.4 million micro businesses within Australia. Around 96% of all businesses in the Australian revenue system are micro businesses. More than 60% of micro businesses are in the property and business services, construction services, finance, primary production or retail industries. Around 60% operate as sole traders or partnerships. The tax paid by micro businesses makes up around 11% of the total tax collected8.

There are over 95,000 SME in Australia, however more than 85% of these businesses have an annual turnover of less than $10 million. Around 92% of SMEs are privately owned, and many are part of a larger group controlled by one or a few individuals. The tax paid by SME businesses is a further 11% of the total tax collected in Australia9.

In Australia, our cash economy compliance activities exist in both Micro and SME markets. This then leads to the question of how we define cash economy. To better articulate and work to address the cash economy risk to the Australian Tax System, we recently revised our definition to:

“The cash economy arises from that area of business activity which takes advantage of the opportunity offered by cash transactions to evade taxation obligations. Typically, this involves the under-reporting or non-reporting of cash income or cash surrogates (for example, through barter activities) by businesses or individuals.”

Our compliance focus

As noted before, in our system based on self-assessment and voluntary compliance, we require an active and targeted compliance approach. Generally, taxation compliance within Australia consists of four key obligations:
- Registration
- Lodgment (or filing as it is otherwise called)
- Accuracy of what is lodged, and
- Payment

Compliance requires all four obligations to be complete. Hence failure in one or more of these key obligations results in non-compliance. There is a hierarchy of activity - registration is necessary before lodgment, and lodgment is necessary before payment or review of accuracy.

Our overall approach to compliance is twofold:
- We want to maximise the number of taxpayers who choose to voluntarily comply by making it as easy as possible for them to understand and meet their obligations.

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9 ibid, pgs 24-25.
At the same time we have strategies to deter, detect and address non-compliance.

We try to find the right balance between our verification and enforcement activities (for example, audits, risk reviews and prosecutions), providing help (for example, education and advice), and making it easy to comply (for example, pre-populating electronic tax returns).

The compliance model directs that we better understand why people are not complying, and that we develop appropriate and proportionate responses. Many factors – business, industry, sociological, economic, and psychological – influence whether a person chooses to meet their obligations. The compliance model itself shows a continuum of taxpayer attitudes towards compliance – from taxpayers who have the desired attitude of being willing to do the right thing to taxpayers who have decided not to comply by choosing to evade tax, or simply opt out of the system. The model also summarises the different sorts of support and intervention that we may need to provide to collect the required revenue. The model suggests that we have the ability to influence taxpayer behaviour through our responses and interaction. We aim to maximise the number of taxpayers at the bottom of the pyramid.

Taking this into account, compliance strategies are commensurate with a taxpayer’s willingness to comply. We have a range of graduated compliance products and approaches intended to create downward pressure to keep people as low as possible in the model. Accordingly, we start action with self regulation strategies like education, record keeping and assistance.

Where a taxpayer makes an honest mistake, or takes ‘reasonable care’ or ‘a reasonably arguable position’ we have a revised penalty regime where a penalty (like interest) is charged at a lesser rate or remitted at the Commissioner’s discretion.

Integrity measures in A New Tax System

Australia introduced A New Tax System (ANTS) on 1 July 2000. The new tax system design centred on the following integrity measures:

- **Australian Business Number (ABN)** – a unique identifier for entities, including individuals, which carry on an enterprise. It is also used across a range of government agencies. It was based on the principle of the Tax File Number (TFN), which is a unique identifier for each Australian.

- **GST Registration** – compulsory where business turnover is greater than $75,000 per annum (until recently this threshold was $50,000), for all participants in the taxi industry, and for charities with a turnover greater than $100,000.

- **Australian Business Register (ABR)** – a public register which can be used to check business information, including GST registration and ABN validity.

- **Tax Invoices** – a valid tax invoice is needed for a business to claim GST input tax credits. Invoices assist in establishing an audit trail. Only a business registered for GST can issue a valid tax invoice.

- **Business Activity Statements (BAS)** – regular reports to the Tax Office summarising an entity’s activities for the period and tax consequences.

- **Withholding when an ABN is not quoted** – if a supplying business does not quote its ABN in a business to business transaction, the paying business must withhold 48.5% of the amount payable, and remit this amount to the Tax Office.

The ABN is a unique 11 digit identifier which:
- helps the business claim goods and services tax (GST) credits
- lets the business claim fuel tax credits that they qualify for
- stops other businesses deducting pay as you go (PAYG) withholding amounts from payments to the registered entity, and
- allows businesses to easily confirm registered entities’ details for ordering and invoicing purposes.

One issue that has emerged has been the cost of compliance for businesses. Over the past seven years the Tax Office has been working more closely with Tax Practitioner bodies and trying to reduce the amount of time and money businesses need to spend to comply with their various obligations.

Part of this has included initiatives to reduce costs by offering more services online through our Tax Agent Business portals on our website, for example, being able to register for GST and submit Business Activity Statements for real-time processing\(^\text{12}\).

Factors that influence participation

There are a number of long term trends in the growth and make up of the Australian population including:
- the continuing influence of migration
- the aging of the workforce
- the growth in the number of retirees
- the increase in workplace participation by women, and
- the populations shift away from the country towards cities.

Audit tools and methodology

A key issue for many small business operators is their ability to understand and meet their taxation obligations. Aligned with this, there is a consistent range of basic problems that are typically found in business in high risk cash economy industries. These problem areas are:
- Record keeping, including poor quality of records and limited knowledge of record keeping requirements
- Cash flow management, including not having the funds to pay taxes when they are due, both collected from customers (GST) and employees (PAYGW) as well as those of the business itself
- Invoicing, including inaccurate invoicing procedures which do not include an ABN or the correct breakdown of the payment for GST purposes, and
- ABN usage, including not using a valid ABN, quoting an ABN in inappropriate circumstances and not withholding from a business when no ABN is quoted.

In 2003-04 the Tax Office undertook the following activities to detect cash economy activities in the Micro and SME segments:

53,766 Micro businesses in listed high-risk industries were contacted, based on risk assessment and/or community information
33,362 letters were sent to Micro business where their performance differed from others in the industry or we received information about potential tax evasion
20,404 Micro businesses were visited by one of 660 tax officers specialising in cash economy reviews
1,594 cash economy compliance field visits were undertaken on SME businesses
702 compliance field visits to SME clients were conducted to review disposal of asset issues
4,938 SME cases were reviewed, with a specific focus on non-lodgment of activity statements and registration integrity.

In the 2004-05 financial year the Tax Office undertook the following activities to detect cash economy activities in the Micro and SME segments:
52,385 Micro businesses were reviewed in high risk industries, based on risk assessment and / or community information
Undertook 9,000 registration checks and 4,400 reviews in the Micro segment regarding non-lodgment of activity statements and income tax returns
Undertook 2,900 visits to Micro businesses by 650 tax officers specialising in cash economy reviews.
Total liabilities raised in the Micro segment for cash economy checks and reviews resulted in raised liabilities of $72.6 million in GST and $49.8 million in other taxes.
1,125 cash economy verifications in the SME segment were completed, resulting in addition revenue of $30 million. Further findings identified omitted income in some businesses with a turnover between $10 million and $50 million.

In 2005-06 the Tax Office undertook the following activities to detect cash economy activities in the Micro and SME segments:
54,400 Micro businesses were contacted by letter, phone or were visited by officers specialising in the cash economy resulting in raised liabilities of $81.2 million and specifically included
370 cases where we used business-to-consumer information to determine if income had been omitted
14 visits to major construction sites to obtain information on payments made by major subcontractors to micro contractors and employees
Sending education letters to over 12,000 people and business across the fishing industry, resulting in 150 operators being identified as omitting income, particularly the non disclosure of sales of licences and quotas
1,060 reviews of SMEs involved in the cash economy were undertaken, resulting in additional total revenue of $41.9 million. Six of these cases with a turnover of between $50 and $100 million resulted in $1.7 million additional revenue.

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14 ibid, pg 27 & 41.
Our ongoing focus

The ATO continues to work with a range of groups to better understand the compliance issues relating to the cash economy, and to develop options for improving compliance. These include:

INDUSTRY – we have formal industry partnerships in place and work with industry groups associated with focus areas throughout our cash economy projects

TAX PRACTITIONERS – a key leverage point in influencing the compliance behaviour of clients. We use a national twice yearly seminar program, quarterly newsletters, a web based “compliance toolkit” for practitioners (advising the proposed activity for each project), and undertake testing of new compliance products, e.g. leverage letters

OTHER GOVERNMENT BODIES – to support a whole of government approach to the cash economy, we are involved in an Inter-Agency Working Group which promotes co-operation, joint activities and exchange of information. We are also promoting the broader uptake of the ABN as a mandatory pre-requisite for registration, licensing etc.

RESEARCH – is helping us to better understand what is driving the cash economy behaviour. In addition to undertaking specific one off research:

- The ATO was involved in a research partnership with the Centre for Tax System Integrity which conducted research, produced a working paper series, and hosted international conferences, and
- Commissioned Blue Moon Research (a specialist research company) in 2004 to provide a report which captured and articulated the community’s perception of the Cash Economy within Australia and has resulted in our current focus towards business to consumer transactions in the 2007-08 year.

COMMUNITY ENGAGEMENT – is a key focus in our approach to increasing community confidence in the tax system. We keep the community informed about the cash economy through media releases (including our successful prosecutions), and inclusion of a cash economy component in the annual Compliance Program booklet. The Tax Office also conducts annual Business Perception Surveys and Community Perception Surveys that help us track our reputation and perception in the community.

Tax Evasion Referral Centre is a confidential phone-in line for the community to report instances of tax fraud. These reports are usually related to the cash economy.
Improving tax compliance in the cash economy

A developed economy perspective on informal sector issues

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Plenary Session – Micro enterprise issues

Overview of the Australian Tax System

- Self-assessment
- Taxes we collect
- Goods and services tax (GST)
- Our role to administer the tax system

Total tax office collections before and after the introduction of the GST (year 2000)
Our compliance focus

- Maximise voluntarily compliance
- Deter, detect and deal with non-compliance

Our compliance approach

- Specific approaches to suit six market segments
- Cash economy compliance activity focus on the Micro segment
- Community attitudes to cash economy
- Factors that influence participation in the cash economy
Our cash economy journey

- Cash economy task force established in 1996
- Australian National Audit Office reports 2002 and 2006
- Move emphasis on *business to business* transactions to both:
  - *business to business* transactions and
  - *business to consumer* transactions
- Revision of cash economy definition to address non-declaring of cash transactions

Impacts of tax system design on cash economy

- Higher degree of voluntary compliance in *business to business* transactions
- Integrity measures such as:
  - Australian Business Number (ABN)
  - Australian Business Register
  - GST registration
  - Business Activity Statement
  - Non-ABN withholding
Change in definition and approach

- Revised definition of cash economy to focus on omitted income
- In 2007-08 introduction of specific strategies to address cash economy risks.

These are:
- Trade and operation benchmarks
- Third party data
- Improvements to receiving and actioning community information
- Conspicuous consumption
- Non-compliance across multiple obligations

Our ongoing focus

- Industry groups and associations
- Tax Practitioners
- Research
- Community engagement