

9 February 2017

Committee Secretary
Senate Committee Tax and Revenue
PO Box 6021
Parliament House
Canberra ACT 2600

By email: TaxRev.reps@aph.gov.au

Taxpayer Engagement with the taxation system

The IPA welcomes the opportunity to provide a submission on the inquiry into taxpayer engagement with the taxation system.

The IPA is a professional organisation for accountants who are recognised for their practical, hands-on skills and a broad understanding of the total business environment. Representing more than 35,000 members and students in Australia and in more than 80 countries, the IPA represents members and students working in industry, commerce, government, academia and private practice. More than 75 per cent of our members work in or with small business and SMEs and are recognised as the trusted advisers to these sectors.

As per the terms of reference for the inquiry, the focus for the committee will be on the cash economy and how to deal with this as a significant contributor to the tax gap. Our submission will respond to this primary focus. Our interpretation of the cash economy can be described broadly as situations where taxpayers operate outside the tax system or are in the tax system but partly conceal revenue or overstate expenses. The cash economy can also be referred to as the shadow or black economy. Participants in the cash economy may also claim government welfare benefits despite contributing little or nothing in the way of taxes.

National Office

Level 6, 555 Lonsdale Street, Melbourne VIC 3000 Australia | GPO Box 1637 Melbourne VIC 3001 Australia

t +61 3 8665 3100 **f** +61 3 8665 3130 **e** natoffice@publicaccountant.org.au **w** publicaccountants.org.au ABN 81 004 130 643

Our tax system operates reasonably well as voluntary compliance under our self-assessment system is relatively high in Australia. The ATO estimates willing participation accounts for 95 per cent of the taxpayer population. All tax jurisdictions have a level of non-compliance. There will always be those who do not fully comply with their obligations, whether through inadvertent error, misunderstanding, or by choice. To completely eliminate non-compliance would impose significant cost on the community and therefore we recognise a trade-off exists.

The ATO undertakes tax gap analysis. Tax gap analysis tries to estimate the gap between tax payable assuming full compliance and the amount actually collected. Historically the ATO has only provided tax gap estimates for GST and luxury car tax. The ATO is currently extending its tax gap analysis beyond the GST and luxury car tax to cover many more revenue streams including income tax for individuals. The ATO is due to report its findings on its extended range of tax gap analysis which will provide some further insights on the level of willing compliance in the tax system for individuals. The Minister for Revenue and Financial Services Kelly O'Dwyer has stated that: "According to the ABS, it is estimated that the black economy in Australia could be as large as 1.5 per cent of our gross domestic product or around \$24 billion dollars". On 14 December 2016, the Minister announced the existence of a Black Economy Taskforce to look into ways to address the black or cash economy and an interim report is due in March 2017. The terms of reference for this inquiry overlap the Minister's black economy taskforce. The Taskforce will look carefully at tax integrity measures that have been successfully employed overseas. The Government has also requested the Board of Tax look into the black economy. It therefore appears that the Government is well advanced in working on developing new tax integrity measures to address cash/black economy tax gap.

Australia's self-assessment tax system relies on high levels of willing voluntary compliance. Voluntary compliance in turn requires an efficient tax system that is perceived to be fair. People who operate outside the tax system or who exploit the

tax system reduce confidence in the tax system and increase the costs for both administrators and other taxpayers. Left unchecked, this will erode willing participation in the tax system and it is imperative that measures are taken to keep the cash economy in check. Australia's voluntary willing compliance relies on agencies taking corrective action to maintain its enviable high levels of voluntary compliance. It is therefore, essential that the tax integrity measures are strengthened to keep the cash economy in check.

The IPA is supportive of measures to address the black economy and provides the following input in response to the inquiry.

Extend withholding tax at source system for contractor's payments to deal with explosive growth of digital economy and black/cash economy

With the growing number of self-employed businesses acting as contractors, the ATO runs a greater risk of losing tax revenue when compared to collecting PAYG from employed individuals. The use of contracting has grown to more than 10% of the workforce and the new opportunities generated from the sharing economy will see further growth. The sharing economy is growing rapidly thanks to the far reaching capability of the internet and the growing use of smart phones. The tax system also incentivises individuals to contracting due to the perceived tax advantages. The tax advantages include the ability to claim a greater range of deductions than an employee, access to lower tax rates and income splitting opportunities. The lower income rate for incorporated businesses has further exacerbated the incentives for a contractor to use a corporate structure to gain access to more favourable tax rates. Employers too are attracted to using contractors as a way to reduce employee on-cost such as superannuation guarantee, leave entitlements and payroll tax.

Another factor is that new entrants into contracting do not need to file a tax return until after the end of the tax year. If they use the services of an accountant it could be 11 months after the end of the year before they need to lodge a return which

could be 22 months after starting out depending on when the business began. The business will then need to pay tax on its first year in business as well as some PAYG instalments for the second year which could impose cash flow issues for the business unless they have set aside money to meet their future tax obligations. Imposing ABN withholding on businesses using the services of contractors can help ease the cash flow issues by setting aside amounts to meet future tax liabilities. ABN withholding amounts would then be offset against any tax liability when the business lodges its tax return.

When the Australian Business Number (ABN) was introduced, it was intended to make significant inroads into the cash economy. Unfortunately the ABN system has not been an effective mechanism for dealing with this sector. There are a significant number of ABNs against where there has been no business activity recorded. There is also widespread practice of quoting invalid or some other entities' ABN details. ABN holders are excluded from the PAYG withholding system unlike employees earning salary and wages. The system requires the paying entity to check the ABN details of the service provider. If this is not done properly, it is relatively easy for an entity to use an invalid ABN or use someone else's ABN details so the veracity of the existing system relies very much on this process. The current system requires businesses to self-assess their PAYG income tax instalments on the basis that they are going to declare all their income in their tax returns. There is only one industry sector that requires reporting of payments made to contractors to enable the ATO to perform a data cross check. Apart from this there is no data matching mechanism to ensure that that all invoices have been included in the taxpayer's income tax return.

A mandated reporting system was introduced in the 2012/13 for the building and construction industry that requires these businesses to disclose payments made to contractors. In its first year of operation an extra \$2.3 billion in voluntary income tax and GST liabilities were reported to the ATO. The majority of the increase can be attributed to the introduction of the taxable reporting system. The reporting system also identified additional liabilities from data matching information reported to it to

identify operators in the cash economy. If other industries with poor compliance history were also brought into the mandatory reporting system, one would expect significant additional tax liabilities being voluntarily reported.

Until the current system's shortcomings are adequately addressed, there needs to be more controls in place to reduce unfair competition resulting from businesses operating in the black or cash economy.

New Zealand has a contractor withholding tax recognising the effectiveness of a withholding at source system for dealing with increasing number of self-employed businesses.

In the IPA's 2017-18 pre-budget submission to Government we recommend an ABN withholding tax system at source be introduced for industries not covered by mandatory reporting of payments to contractors. The withholding rate can be industry specific to reflect differences in profitability or a tailored rate that a business applies for to reflect individual tax circumstances. Mandatory reporting has shown to be a very effective mechanism for prompting taxpayers to re-join the tax system ahead of possible detection through data matching. The experience shown in the Construction and Building Industry has proven that mandatory reporting has been able to reverse entrenched longstanding non-compliance behaviour. It has encouraged reluctant contractors to engage with the tax system in a positive way. Not only has taxable payments reporting resulted in measurable improvements in compliance by contractors it has exposed areas of non-compliance (Missing ABN details, invalid ABNs etc.). An ABN withholding will also address the risks associated with an increasing number of self-employed businesses generated from the sharing economy.

It is important to note that a reportable payment system or ABN withholding will only cover business to business transactions. Other measures will need to be implemented to address businesses dealing directly with the public. Part of the strategies to address this will involve consideration of ways to change community attitudes which are well entrenched. Imposing an ABN withholding event on members of the public would not be practical. The Government needs to help the

ATO make tax compliance more embedded in how the community thinks and operates through education. The Government cannot rely solely on the ATO to change community attitude towards tax compliance. Community attitudes to the cash economy are an important factor in influencing voluntary compliance. The ATO has developed cash economy benchmarks for high risk industries in which business to consumer transactions represent a major proportion of total business income.

Strategies employed in other countries to address consumer to business cash economy include:

- Restricting the use of cash transaction as a method of consideration and mandating electronic payment. Cash transactions are intrinsically the most difficult for the ATO to identify and monitor.
- Reduce community tolerance of the cash economy through education
 - Raise community understanding of the role played by taxes in achieving social equity objectives and providing essential public services and infrastructure. This needs to be a whole of Government approach rather than the ATO on its own. The key theme will be that taxes are the price we pay for a civilized society. Strong discipline around government outlays will also be needed to in securing community support for our tax system.
 - Introducing tax education at an early stage in the school curriculum to embed the concept that tax is a community obligation in exchange for entitlements and protections afforded to law-abiding members of the community
- Imposing penalties on consumers who do not obtain a valid ABN tax invoice
- Raise awareness of dangers of dealing with cash economy highlighting the risk of poor quality of workmanship, health and safety issues associated with dealing with business operators and tradespersons who may also not be meeting other legal and industry obligations
- Forcing retailers to upload and transmit daily sales data direct to the revenue authority for data matching

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t +61 3 8665 3100 f +61 3 8665 3130 e natoffice@publicaccountant.org.au w publicaccountants.org.au ABN 81 004 130 643

- Domestic tax amnesty to encourage hidden economy to engage with the tax system by offering reduced penalties

The IPA welcomes the opportunity to discuss further any of the matters we have put forward in our submission. Please address all further enquires to myself (tony.greco@publicaccountants.org.au or 0419 369 038).

Yours sincerely,

General Manager Technical Policy
Institute of Public Accountants