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Ethics and Integrity in Tax Administration

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# Ethics and Integrity in Tax Administration

Michael Walpole

## **Abstract**

This paper considers ethics and integrity in tax administration. The paper specifically focuses on income tax self assessment and issues associated with it in the context of ethics and integrity. Then the paper considers the Australian tax compliance model along with the roles of tax advisors and of tax administrators in the self assessment process and suggests some strategies for encouraging an ethical approach by both of these groups as well as taxpayers in an income tax system.

# **Ethics and Integrity in Tax Administration**

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## **Introduction**

This paper has been written in response to a request to speak at this conference. I am flattered and honoured to be speaking here today. The request that was made placed the topic that I have been given in the context of income tax self assessment and I will, later in the paper, attempt to identify issues associated with the topic that are linked and relevant to self assessment. However, many of the things that can be said about ethics and integrity are not confined to self assessment but apply equally to many other aspects of the process of providing/gathering tax information and determining the correct amount of tax to be collected (with the further step of actually collecting the amount). That having been said, self assessment is probably the ultimate delegation of decision making in an income tax system, because it allows the taxpayer to control to the greatest degree the process of determining their tax liability. This makes it a significant decision worthy of specific consideration.

The structure of the paper is to introduce the topic with some definitional considerations of what is meant by ethics and integrity in this context, and then it discusses the consequences of a departure from adequate standards of ethics and integrity, relying on the tax policy, especially literature. With this background the paper considers self assessment specifically and because I am Australian and have an Australian (although not exclusively) perspective on such things, it will discuss the

Australian tax compliance model. Then the paper considers the roles of tax advisors and of tax administrators in the self assessment process and suggests some strategies for encouraging an ethical approach by both of these groups as well as taxpayers in an income tax system.

### **Meanings and perceptions of integrity and ethics**

As a starting point it is necessary to consider the obvious – to determine what integrity is in a tax system and to consider what role ethics play in a tax system. The point of this is to demonstrate that sometimes there is conflict between expectations of administrators and tax advisers and even of taxpayers in relation to what is done by these players when they perform their duties. A simple analogy that illustrates this is the example of legal practitioners in Australia. There can be no doubt that although they owe a duty to the courts they also have a paramount obligation to their clients. In taxation they are, it seems, ethically bound to ensure that their client pays the minimum amount of tax. Just as a taxpayer is entitled to obtain legal advice before entering into a legal transaction, the lawyer has a positive duty to give appropriate advice. That advice may not be such that encourages the doing of something that is illegal – but it must be full and professional and should extend to advising their client how to pay the least amount of tax that it is legal to pay. The lawyer has no obligation to judge the morality of the taxpayer.<sup>1</sup> The duty to give correct advice can, in Australia, be very onerous. In addition the common law doctrine of legal professional privilege may oblige the lawyer to reveal nothing of the instructions and advice that have passed between lawyer and client without the client's clear and specific permission. Accountants have a similar obligation to their clients to ensure they act in their clients' best interests.<sup>2</sup>

Thus there may be a perception on the part of administrators that professionals always act in a manner which is adverse to the interests of the public purse. But this apparent bias and corruption on the part of professionals may in fact be only a perception arising from professionals doing no more than acting professionally. What is clear,

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<sup>1</sup> See Alan Meyers QC, 'Tax Advice: The lawyer's ethical responsibility', *Australian Law News*, March 1990 at p 17.

<sup>2</sup> See *Bell v Vahexi* 40 ATR 459, discussed further below.

however, is that professionals are usually bound to ethical standards imposed and administered by their professional bodies in Australia and in addition have recently been made subject to severe sanctions should they engage in large scale promotion of tax avoidance schemes. Under additions to the *Taxation Administration Act*<sup>3</sup> a new regime of penalties was introduced (the promoter penalty laws) which deter through penalties the promotion of schemes designed to exploit tax avoidance opportunities in the law and the use of product rulings in manner materially different to that described in the ruling so as to achieve a tax avoidance outcome. Furthermore there is no permission for practitioners to mislead tax authorities or to lie or cheat on behalf of their clients.

On the other hand there is an obligation on the part of the administrator to recover from taxpayers the maximum amount of tax that the taxpayers are obliged in law to pay.<sup>4</sup> This implies two things – one is that tax administrators are not permitted to exceed the bounds of the law in securing payment of tax, nor are they permitted to waive or moderate legal rules in return for private benefit. Thus they can not use undue pressure going beyond the law to coerce taxpayers to pay something (whether or not it is due) nor can they use their position of power over taxpayers to receive private benefits such as bribes or favours. In conventional theory, administrators are as much servants of the populace with whom they deal as they are servants of the authority that employs them. This is illustrated in the expectations of the Inland Revenue Board of Malaysia (IRBM) Audit officers as spelled out in the relevant guidelines which list the following expectations of audit officers:

“An audit officer must adhere to rules and codes of ethics drawn up by IRBM and is required to carry out his duties in the following manner:

- 8.1.1.1 Professional, well mannered, trustworthy, honest and with integrity;
- 8.1.1.2 Always ready to give explanations on the objectives of the tax audit and the rights and

<sup>3</sup> Division 290 of Schedule 1 to the *Taxation Administration Act 1953*.

<sup>4</sup> See for example para 4 English version *Tax Audit Framework*, IRBM, January 2007.

- responsibilities of the taxpayer;
- 8.1.1.3 Knowledgeable and fair in administering tax laws;
  - 8.1.1.4 Co-operative and always ready to give advice and guidance to the taxpayer;
  - 8.1.1.5 Ensure that the audit is carried out smoothly with minimal disruption to the taxpayer;
  - 8.1.1.6 Request for documents, books of accounts and information that are relevant to the audit only;
  - 8.1.1.7 Explain the proposed tax adjustments and provide reasonable time for taxpayer to give responses on issues raised; and
  - 8.1.1.8 Ensure the rights and interest of taxpayers and tax agents as well as documents of taxpayers are safeguarded;”<sup>5</sup>

Furthermore it should be noted that:

“An audit officer is prohibited from:

- 8.1.3.1 Having any personal or financial interest in the business of a taxpayer being audited;
- 8.1.3.2 Recommending to taxpayer that a certain tax agent be appointed as the tax agent for the audit case; and
- 8.1.3.3 Abusing his position or power in carrying out his duties as provided under section 118 of the ITA.”<sup>6</sup>

On the other side of tax administration we should consider the obligations of taxpayers. These are to keep adequate records; to timeously provide the information that they are legally obliged to; to cooperate in accordance with the law when called

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<sup>5</sup> Para 8.1 English version *Tax Audit Framework*, IRBM, January 2007.

<sup>6</sup> Ibid.

upon to do so and to be truthful. Their obligations in an audit are spelled out in a manner similar to that above in the *Tax Audit Framework* guidelines,<sup>7</sup> the most important of these are the expectation that the taxpayer will behave in a manner that is “...fair, honest, and with integrity...”<sup>8</sup> In particular it should be noted that the taxpayer is enjoined in the guidelines,<sup>9</sup> on pain of criminal penalty not to, provide “...any form of gifts to the audit officer and transacting any business with the audit officer during the audit process” nor to make “...any form of payments to the audit officer;” as well as required not to be obstructive or hinder the audit officer.

Thus when we speak of integrity and ethics in the tax system we refer to departures from the respective codes governing the behaviour of the taxpayers, tax advisers and officials referred to above. It is submitted that this is a somewhat narrower perspective than one that might, for example, focus on legal but undesirable tax avoidance practices. The next part of this paper considers part of the large body of literature on corruption that is relevant to the topic.

### **The harm of corruption.**

It is intuitive that corruption in tax is harmful and it is therefore comforting and encouraging to find that the academic literature on the topic bears this out. A highly influential source that takes this view is the International Monetary Fund (IMF). In his work “Corruption and public finance: an IMF perspective” which is an introduction to an entire volume of opinions by IMF staff, Ayre L. Hillman makes several points about the impact corruption has on public finance, especially in countries with relatively low income.<sup>10</sup> A starting point for him is that corruption is almost inevitable in human society. He refers to Vito Tanzi who “...points out that corruption ... has been endemic in human civilization...”<sup>11</sup> and that as government has grown so

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<sup>7</sup> Id para 8.2.

<sup>8</sup> Id, para 8.2.1.1.

<sup>9</sup> See especially para 8.2.2 and sub paras of *Tax Audit Framework*, IRBM, January 2007.

<sup>10</sup> “Corruption and public finance: an IMF perspective” Ayre L. Hillman, *European Journal of Political Economy* Vol. 20 (2004) 1067 – 1077. In this work Hillman reviews the book *Governance, Corruption, and Economic Performance*, George T. Abed and Sanjeev Gupta (Eds) IMF Washington (2002).

<sup>11</sup> Id, p 1068. The reference is to Tanzi’s chapter *Corruption around the world: causes consequences, scope and cures* at p 25. Tanzi’s definition of corruption is also narrow – i.e. “the abuse of power for private benefit” (id) and distinguishes bribes from gifts whilst noting that there is a cross over point at which a gift becomes a bribe.

has corruption. According to Tanzi (via Hillman) increased "...regulation, taxation, procurement, and public spending for private benefit all provide foundations for corruption."<sup>12</sup> Hillman then makes the point that "...abolishing the state would abolish corruption because all transactions would take place in markets, and people could exchange gifts as well, if they wished." This somewhat wry comment does serve to highlight that it is the underlying contest between personal interest and those of the wider community via the state that creates the conflict of interest which makes a corrupt practice corrupt. The costs of this are immense, according to Tanzi who explains that:

"People become disillusioned with markets (to the extent that free markets are present), with democracy (where present) and with the government itself; the intentions of government regulations and policies are subverted and property rights and the rule of law are compromised, as are markets and incentives. Income distribution is also made more unequal, with the poor likely to lose the most from corruption."<sup>13</sup>

Thus it seems corruption can tear at the very fabric of government and society. According to Hillman Tanzi and Davoodi have found "...data showing that high-corruption countries have had lower growth."<sup>14</sup> Hillman says the links between low growth and corruption "...are that (1) corruption discriminates against small enterprises; (2) corruption discourages private investment; and (3) corruption directs talent or personal abilities to unproductive activities (seeking and extracting rents)."<sup>15</sup> As growth is associated with small enterprises the discrimination against small enterprises suppresses growth. Other indicators from the evidence are that corruption favours larger enterprises which use corruption to protect themselves from competition rather than using activities more stimulative of growth. In addition direct foreign investment is discouraged and joint ventures with local partners are stimulated because investors need local partners to protect them from corruption.<sup>16</sup>

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<sup>12</sup> Ibid.

<sup>13</sup> Id 1069.

<sup>14</sup> Id 1071 referring to Vito Tanzi and Hamid Davoodi in their chapter *Corruption, growth, and public finance*.

<sup>15</sup> Id 1071.

<sup>16</sup> Id 1071.

Of more concern is the evidence that

“[c]orruption ... increases unproductive public investment. High corruption is also associated with lower operation and maintenance expenditures, which explains why development projects fail to continue after aid resources have been made available and aid-provided project managers have departed. High corruption is also associated with poor-quality public infrastructure. All of these effects reduce growth.”<sup>17</sup>

Another dampening effect on growth apparently includes an increase in the number of students studying law in more corrupt countries – which reduces growth.<sup>18</sup> The research described by Hillman also identifies some very significant aspects of the taxation system. Corruption, he claims, is “rampant” amongst officers who collect tariff revenue.<sup>19</sup> In addition the process of collecting individual income taxes attracts corruption “...because of the mutual interest of the tax inspector and the taxpayer to underreport income.”<sup>20</sup> The effect of this is that countries which suffer high corruption find that “...the revenue available for public finance is low...”<sup>21</sup> because although the community are paying high costs in taxation and corrupt payments the revenue does not all reach the government and such revenue as does makes its way into the public purse “...is spent in unproductive ways or is privately appropriated before reaching designated public expenditure objectives. Corruption thus makes public finance quite ineffective.”<sup>22</sup> Corruption can obviously reduce the tax take of the revenue authority – but some taxes are better than others as “The introduction of VAT to replace other taxes ... reduces corruption because of the compliance requirements and interconnections between reporting by buyers and sellers.”<sup>23</sup>

Other research adverted to by Hillman, explores more aspects of the government expenditure side of the economy in countries experiencing corruption. Referring to

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<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

<sup>19</sup> Ibid.

<sup>20</sup> Ibid.

<sup>21</sup> Ibid.

<sup>22</sup> Ibid.

<sup>23</sup> Ibid.

the work of Paulo Mauro<sup>24</sup> Hillman explains that corruption provides the corrupt with lucrative options for personal gain and this changes the composition of government spending. Where public expenditure is made on items that are not easy to value whether through ambiguity of value or lack of ease of price monitoring corruption is assisted. This makes military expenditure<sup>25</sup> and high technology expenditure particularly susceptible; and, for example expenditure on salaries of health workers is less prone to corruption than expenditure on medical equipment.<sup>26</sup> There also seems to be opportunity for corruption where the expenditure involved involves the exercise of an official's discretion. Thus the example quoted is that pensions based on age (an objective criterion) are less open to corruption than pensions based on discretion such as a disability.<sup>27</sup> Other data illustrates how damaging the biases in public spending can be and Hillman quotes Gupta et al who link corruption to higher levels of infant mortality; school drop outs; and low birth weights.<sup>28</sup> Put crudely it seems corruption kills babies. It also increases costs for consumers of public goods like transport.<sup>29</sup> Other examples of the harm caused include low quality infrastructure because the cost of bribes is met through savings in quality of materials and similar activities undermining the effectiveness of public spending.<sup>30</sup> Not only does corruption undermine the effectiveness of capital expenditure it should also be noted that it contributes to social inequality.<sup>31</sup>

All of this commentary is helpful in giving incentive to governments in ensuring integrity of the tax system from an administrative perspective. What of the risks to the system through a lack of integrity by taxpayers and their advisers? The next part of this paper considers that perspective.

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<sup>24</sup> Hillman is quoting from P. Mauro "Corruption and government expenditure" (1998) *Journal of Public Economics*.

<sup>25</sup> This is borne out also by the work of S. Gupta, L. de Mello and R. Sharan "Corruption and military spending" (2001) *European Journal of Political Economy*. Referred to by Hillman at 1073.

<sup>26</sup> Hillman, id 1072.

<sup>27</sup> Ibid.

<sup>28</sup> Id 1072. The reference is to S. Gupta, H. Davoodi and E Tiongson "Corruption and the provision of health and education services".

<sup>29</sup> Id 1072. The example given is the massive decrease in costs of transport and transport infrastructure in Milan after a corruption ring was destroyed. The reference on this is to V. Tanzi and H. Davoodi "Corruption, public spending and growth".

<sup>30</sup> Id 1073.

<sup>31</sup> Id 1076. Here Hillman is referring to S. Gupta, H. Davoodi, and R. Alonso-Terme "Does corruption affect income distribution?" (2002) *Economics of Governance* whose work has shown "...empirically that corruption changes income distribution to the disadvantage of the poor in poor countries." (Ibid).

## **The harm of poor taxpayer integrity.**

The conventional view is that tax evasion and tax avoidance are harmful. They undermine the tax base and provide government with less revenue than they are otherwise able to collect<sup>32</sup> thus undermining their ability to govern for the benefit of all. There is also a moral argument/social contract that tax must be paid by the members of a society as they owe loyalty to the society.

According to Tanzi and Shome

“Tax evasion affects the horizontal and vertical equity of a tax system, as well as the efficiency of the market and the tax system. Unchecked or poorly controlled tax evasion builds cynicism about the public sector. It tends to complicate the tax structure as legislators try to anticipate tax evasion through tax legislation.”<sup>33</sup>

The same authors recognise that evasion is something that is endemic and that has been with society for thousands of years. They note that even Plato (428-347 BC) wrote about it.<sup>34</sup> It “prosper”, they say,<sup>35</sup> “when society condones it”<sup>36</sup> and although tax evasion is a limited and isolated phenomenon in a society which does not condone it, “when society condones it the phenomenon becomes much more widespread.”<sup>37</sup> They suggest that controlling and discouraging evasion is a responsibility shared by a society, especially the governing elite.<sup>38</sup>

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<sup>32</sup> Vito Tanzi, Parthasarathi Shome “A Primer on Tax Evasion” *Staff Papers - International Monetary Fund*, Vol. 40, No. 4 (Dec., 1993), pp. 807-828, 810.

<sup>33</sup> Vito Tanzi, Parthasarathi Shome “A Primer on Tax Evasion” *Staff Papers - International Monetary Fund*, Vol. 40, No. 4 (Dec., 1993), pp. 807-828, 819.

<sup>34</sup> *Id.*, 807.

<sup>35</sup> *Id.*, 817.

<sup>36</sup> This is seemingly borne out by the experimental work of James Alm, Isabel Sanchez, and Ana de Juan, 1995. “Economic and Noneconomic Factors in Tax Compliance,” *Kyklos*, Blackwell Publishing, vol. 48(1), pages 3-18.

<sup>37</sup> Vito Tanzi, Parthasarathi Shome, 817.

<sup>38</sup> *Ibid.*

This approach suggests that damaging evasion in the taxpayer community is within the gift of the government to address. Some suggestions for how this control might be exercised will follow.

In the next section of this paper there follows a discussion of how the seemingly endemic problem of poor taxpayer integrity is fostered by a self assessment system.

### **Self assessment.**

The rationale for self assessment income tax systems is usually that that they afford a profitable diversion of resources. In Australia the income tax self assessment approach has been said to impose "...a considerable burden on taxpayers, because the taxpayer may be liable to significant penalties for errors in returns or other 'statements' to the ATO or its officers."<sup>39</sup> This comment reveals the purpose and effect of most modern self assessment systems. By requiring the taxpayers to collect collate and record the relevant information to enable them to come to their own assessment of their tax position – and then to calculate the tax, the revenue collection agency does not require the services of "assessors". These personnel are then freed from other duties to undertake checks, whether random or targeted, probably both, of the information that taxpayers have provided and thus collection can be aimed at the non complaint and the sources of greater revenue and can be diverted from unnecessary dealings with the compliant (or low risk) or with those on whom attention should be focused because they are a source of large amounts of tax. Thus, in essence, by requiring taxpayers themselves to ascertain their own tax liability the resources of the tax collection agency are liberated for tax administration and enforcement.

This approach implies that there will be taxpayers whose self assessed returns will either be ignored by the revenue authority, or at least given only a perfunctory examination. The information they have provided will not be examined in any depth unless attention is drawn to it for some reason. Such a reason may be that the taxpayer

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<sup>39</sup> R. Woellner, S Barkoczy, S. Murphy and C. Evans *Australian Taxation Law* (2009) CCH, page 1,776.

themselves attract attention – such as by varying their assessment; or it may be that the taxpayer’s self-assessment has been selected for checking. As the Australian Taxation Office (ATO) explains on its internet web site:

“Although we do not check the accuracy of your tax return at the time of processing, at a later date we may examine the details more thoroughly by reviewing specific parts, or by conducting an audit of your tax affairs. We also have a number of audit programs that are designed to continually check for missing, inaccurate or incomplete information.”<sup>40</sup>

The ATO seems very committed to self assessment in Australia. Its enthusiasm is borne out by comments by the Commissioner of Taxation who has commended it on grounds of efficiency and integrity.<sup>41</sup> The enthusiasm (although apparently based on the Japanese experience rather than the Australian) was shared by the MIRB which identified several objectives in its introduction of self assessment – modernisation; efficiency; and increased compliance.<sup>42</sup>

The next section of this paper examines whether the adoption of self assessment poses particular challenges to the maintenance of taxpayer integrity and whether this encourages lack of compliance.

### **Is honesty more important in a self assessment environment?**

It might be assumed that self assessment leads to poorer tax compliance because the fact that the taxpayers must, for example, declare their own income and identify their own deductions they will be tempted to lower their liability for income tax. Their natural tendency to act in their own best interests will be reinforced by the knowledge that their tax return will be processed but not subject to rigorous checking and assessment like it was in the days of an official assessment process. This may be so – the temptation to understate their tax liability and to take a risk must exist in the case

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<sup>40</sup> “Why do we pay tax and what is self-assessment?” at <http://www.ato.gov.au/individuals/content.asp?doc=/content/34572.htm> (accessed 15 July 2009).

<sup>41</sup> See “Checks and balances ensure tax integrity”, Media Release Nat 98/29 (1998) Australian Taxation Office.

<sup>42</sup> According to E. C. Loo, and M. McKerchar, “Self Assessment System in Malaysia – Performance to date and challenges ahead.” *Tax in ASEAN and China: Regional challenges and integration conference*, ATAX, UNSW, July 2009, at p 5-2. The authors rely on *IRB Annual Report 2006*.

of some taxpayers – but one must ask whether the problem of under assessing is widespread and of concern.

There is no shortage of research on this subject. One team of researchers<sup>43</sup> has pointed out that taxpayers who expect a refund will tend to avoid the risks of tax evasion – because they may lose the gain of the refund. Whereas others who expect to have to pay more tax are also more likely to be tempted to evade that liability. Thus a Revenue authority might be tempted to ensure that as far as possible tax is over collected or over withheld so that self assessment leads to refunds. But it is not the purpose of this paper to seriously propose such a tax system design without much more analysis. What the work of these researchers does make clear as a result of their experiments, however, is that increased opportunity to evade tax certainly leads to increased evasion.<sup>44</sup> In their experimental work it was made clear to participants completing tax information that they would not be audited. This makes the role of the tax authority critically important in that taxpayer honesty will be supported by an administration that limits opportunities for dishonesty. Self assessment is itself a step in the opposite direction and opens up opportunities for dishonesty. Indeed at one extreme Halperin and Tzur suggest that high penalties for evasion plus high audit rates are well established in the research “...as an effective way of reducing tax evasion”<sup>45</sup> This suggests that an increase in the risk faced by evaders is effective in discouraging evasion. This author hastens to point out, however, that one can go too far in this and an overly oppressive tax system can, for reasons discussed below, cause behaviour opposite to that intended.

Opportunity is not the only factor in tax evasion. This has been identified in other research. Perceptions of fairness are also relevant. A literature review by Wallschutzky reveals motivations for tax evasion include perceptions of high tax

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<sup>43</sup> Henry S.J. Robben, Paul Webley, Henk Elfers, and Dick J Hessing “Decision Frames, Opportunity and Tax Evasion. An Experimental Approach” (1990) 14 *Journal of Economic Behaviour and Organisation* 353-361, 354.

<sup>44</sup> *Id.*, 359.

<sup>45</sup> Robert Halperin and Joseph Tzur, “Tax Evasion and the Low Penalty, Low Audit rate Phenomenon”, (1990) 9 *Journal of Accounting and Public Policy*, 179-196, 179.

rates;<sup>46</sup> government profligacy with tax revenue;<sup>47</sup> and an overly coercive tax administration.<sup>48</sup>

These fairness perceptions thus include fairness as to who is paying tax as well as fair treatment of taxpayers. This suggests that both policy based fairness in the tax system as to who is taxed and how much, and fairness and even handedness by the tax authority are required to encourage integrity amongst taxpayers. Indeed Wallschutzky's work with known tax evaders appears to emphasise taxpayer dissatisfaction with their treatment by the ATO as a possible "...important influence on future levels of tax evasion."<sup>49</sup> The somewhat surprising suggestion by Wallschutzky seems to be that even tax evaders must be fairly treated as a means of ensuring they do not evade again.

In addition to this consideration of fairness which might accompany firmness displayed by a tax authority in dealing with evaders, fairness must also be evident to taxpayers who are not evaders. Indeed the work of Wallschutzky and others seems to suggest that overly harsh treatment of the compliant may make them non-compliant because they see their treatment at the hands of the tax system as unfair. The fair treatment of taxpayers is one of the considerations underlying the ATO's approach to tax compliance.

### **Compliance model in Australia.**

The ATO has published aspects of its approach to tax compliance. A key aspect of this seems to be that it does not regard all taxpayers alike. The tax compliance model<sup>50</sup> is represented in the form of a pyramid, wider at the bottom than at the top.

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<sup>46</sup> Ian Wallschutzky "Causes of Tax Evasion" *Journals of Economic Psychology* 5 (1984) 371 – 384, 374. Wallschutzky is referring to the work of P. Dean, T. Kennan, and F. Kenney, "Taxpayers' attitudes to income tax evasion – an empirical study" (1979) 1 *British Tax Review* 28-44.

<sup>47</sup> Dean et al, 43.

<sup>48</sup> Wallschutzky, id, referring to work of G. Schmolders, "Survey research in public finance: a behavioural approach to fiscal policy" (1970) 25 *Public Finance*, 300-306; M.W. Spicer and S.B. Lundstedt "Understanding tax evasion" (1976) 31 *Public Finance*, 295 – 305; M. Frank and D. Dekeyser-Meulders "A tax discrepancy coefficient resulting from tax evasion or tax expenditures" (1977) 8 *Journal of Public Economics*, 67-78.

<sup>49</sup> Wallschutzky, 383.

<sup>50</sup> The model is available at <http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm> (accessed 18 July 2009).

This pyramid represents the whole of the population of taxpayers. The bottom of the pyramid at its widest are the most numerous taxpayers. These taxpayers are viewed as “willing to do the right thing”.<sup>51</sup> The next level up the pyramid is narrower but still quite wide and this group are described as “Try to [comply] but don’t always succeed.”<sup>52</sup> Less numerous still and higher on the pyramid are the group regarded as not wanting to comply and the highest level of the pyramid is occupied by those who “[h]ave decided not to comply”.<sup>53</sup> These are the least numerous taxpayers and thus it can be assumed that only a relatively small group of taxpayers appear to deserve being treated as intransigent, non compliant law breakers. This point is worth considering in the context of the discussion above about perceptions of unfairness. There may be a risk that if all taxpayers are treated as if they have decided not to comply they will feel that they are being treated unfairly.

The impact that such model has on the approach to be used by a revenue authority in its relations with taxpayers will be discussed further below under the heading of the role of the tax administration. It is not only the revenue body that has a role, however, in how tax is handled. Professional advisers to taxpayers also do so. In Australia the level of use of tax agents is particularly high and this places tax agents and similar professionals in an important position in the whole of the tax system. The next section of this paper will consider that position.

### **Role of tax agents/profession.**

The role of their advisers is critical to the compliance behaviour of taxpayers. Although the extent to which professional advisers are used in Malaysia may be different, in Australia taxpayers and therefore the ATO are heavily reliant on tax agents. According to the Commissioner of Taxation in Australia, in 2005

“73% of individuals and 94% of companies choose to use tax agents. As at 31 July 2005, the number of registered tax agents was 25,965. Of these there were:

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<sup>51</sup> Ibid.

<sup>52</sup> Ibid.

<sup>53</sup> Ibid.

21,571 active agents (who are new or have lodged a return in 2003-04), including, 11,671 active agents with 100 or more clients.”<sup>54</sup>

There is an extensive list of tax agents authorised by the MIRB.<sup>55</sup> Tax agents are thus an important player in the tax systems of both nations. Indeed their position in Australia is so important that it has been subject to a major revamp under recent legislation which has replaced the former partially state based Tax Agents’ Registration Board with a new national Tax Practitioners Board.<sup>56</sup> The new Board, although enacted, is still being assembled at the time of writing and thus has no track record on which to comment. The legislation that has established this new Board includes important elements applicable to such an important and influential group of professionals. These include criteria for registration such as that the person is (or in the case of a company all of the directors are) a “fit and proper person”<sup>57</sup> and that the person/s meet requirements specified in regulation as to educational qualifications and experience. Specifically excluded from registration are persons who have committed “a serious taxation offence”.<sup>58</sup> As to what criteria are applied in determining whether an applicant is a “fit and proper person” the Registration Board must have regard to a list<sup>59</sup> including whether the person “is of good fame, integrity and character” and whether in the past 5 years they have served or been sentenced to a term of imprisonment or have been “convicted of an offence involving fraud or dishonesty”; “been penalised for being a promoter of a tax exploitation scheme”; been penalised for implementing a scheme promoted on the claim of conformity with a product ruling issued by the ATO but which “is materially different from that described in the

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<sup>54</sup> Michael D’Ascenzo (then Second Commissioner of Taxation), “Relationships between Tax administrations and Tax Agents/Taxpayers”, Presentation, to the Study Group on Asian Tax Administration and Research (SGATAR) of the Asia-Oceania Consultants Association (AOTCA) general meeting, Manila 11 November 2005. See

<http://www.ato.gov.au/corporate/content.asp?doc=/content/66215.htm> (accessed 19 July 2009).

<sup>55</sup> These are listed geographically from the IRB website under “Tax Info”. See for example <http://www.hasil.org.my/english/EJENCUKAI05/english/JOHOR.asp> (accessed 19 July 2009).

<sup>56</sup> Established under the *Tax Agent Services Act 2009*.

<sup>57</sup> See cl 20-5 Tax Agents Services Bill 2008.

<sup>58</sup> *Id.*

<sup>59</sup> See cl 20-15 Tax Agents Services Bill 2008.

product ruling”; become an “undischarged bankrupt” or gone “into external administration”; or sentenced to a term of imprisonment.<sup>60</sup>

It will be clear from this that tax agents are faced with the loss of their livelihood from operating as tax agents if they commit offences especially serious tax offences. This would amount to a considerable and serious sanction to control their behaviour. This is seen as necessary because they are placed in a somewhat invidious position. As they charge a fee for their services their clients will often not only expect that they complete a tax return competently and correctly but may expect that the cost of using a tax agent (a cost that is in itself tax deductible in Australian tax law) will be offset by a refund of their tax. Not every taxpayer is likely to be entitled to such a refund and thus there must be some pressure in certain quarters of the taxpayer community for their tax agent to secure them some level of refund. All the same fraudulent claims by tax agents on behalf of their clients could not be tolerated and thus are not. There is evidence in some research that taxpayers who have low integrity are likely to choose to use tax advisers who demonstrate similar low levels of integrity.<sup>61</sup>

The same cannot be said of advice or actions that are not actually fraudulent tax evasion but falls into the category of avoidance. There are high expectations placed on tax advisers in Australia if they fall within one of the professions that may also represent taxpayers.

The difficulty can be summarised in a submission to the *Australian Senate Economics References Committee Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection* in 2001/2.<sup>62</sup> Apparently

“A solicitor in his submission to the Senate Committee raised a professional concern in relation to this issue. He said:

... not only is it our obligation to advise on the law as it is—we can be sued if we do anything else—but if we fail to advise a client that a

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<sup>60</sup> All these requirements are set out in cl 20-45 Tax Agents Services Bill 2008. It is noticeable that the references to sentencing to a term of imprisonment are frequently repeated.

<sup>61</sup> Yuka Sakurai & Valerie Braithwaite, *Taxpayers' Perceptions of Practitioners: Finding One Who Is Effective and Does the Right Thing?* (2003) 46 *Journal of Business Ethics* 375, 385.

<sup>62</sup> See [http://wopared.aph.gov.au/Senate/committee/economics\\_ctte/completed\\_inquiries/2002-04/massmark/interim\\_rep/index.htm](http://wopared.aph.gov.au/Senate/committee/economics_ctte/completed_inquiries/2002-04/massmark/interim_rep/index.htm) (accessed 19 July 2009).

transaction can be carried out in a more tax effective manner, we can be sued for negligence by that client.”<sup>63</sup>

The situation is no different in most other jurisdictions.<sup>64</sup> Thus the agent is likely to be under pressure to give tax effective advice to clients for commercial and professional reasons, whilst being required, subject to criminal sanction, to ensure they are not party to actual tax evasion. In my experience the point that professional representatives owe an ethical duty to their clients to give advice leading to tax reduction, and that in the absence of a general or specific anti-avoidance provision they are committing no legally punishable wrong (in fact quite the opposite) is not always fully appreciated by personnel within revenue authorities. In short, in many circumstances the tax agent owes a greater duty to their client than to the revenue collection agency. The role of the tax administrative body in managing this tension is discussed next.

### **Role of tax administration.**

In the previous parts of this paper the case has been made that the tax administration is as prone as any other human activity to lapses of integrity within its own organisation. This much is obvious and there are many obvious responses to such lapses including the maintenance of a culture of high integrity and the design of checks and balances to ensure that opportunities for corruption are limited through the “sunshine” of visibility. Included in this should be tax law design elements such as limiting the extent to which individual officials are left alone to deal with taxpayers in making decisions about their affairs. The less discretion a system allows to an official the more difficult it is for a corrupt official to have any discretion which may be subject to undue influence. Aside from obvious internal cultural and preventative changes, which address lapses in integrity within the tax administration system, the question should be asked what role does the tax administration have in developing and ensuring integrity within the taxpayer community.

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<sup>63</sup> ATAX UNSW, *Critical Perspectives and Ethics*, at 4-23.

<sup>64</sup> “If the advisor does not advise their client on how to reduce the tax through restructuring and using one of the treaties, it is malpractice not to do so”, Prof D. Duff University of British Columbia, speech to Oxford University Centre for Business Tax Conference *Competition and Coherence: New Directions for International Taxation*, 11 July 2009.

The discussion of compliance above has made the case that:

Tax evasion is endemic in human society;

Some taxpayers are more likely to engage in acts of evasion than others;

Tax evasion arises where there is opportunity (such as under self assessment);

Tax evasion is linked to taxpayer attitudes e.g. perceptions of unfairness in the tax system;

Tax advisors are an important player in the tax collection process.

Faced with these issues how should a tax administration respond?

1. Some taxpayers are more likely to engage in acts of evasion than others;

It is submitted that one of the important aspects of this statement is the use of the term “some”. Not all taxpayers are dishonest and if the ATO compliance model discussed above is to be believed, the majority of taxpayers need no more than that compliance be made easy, or at worst they need assistance in complying. In Australia activities such as electronic lodgement of tax returns and the issue of rulings that may be relied upon by taxpayers are attempts to provide such ease and assistance.

Such activities can impose considerable costs and expectations on revenue administrations but if it is considered in the context of the cost of not collecting tax and especially ironically of not collecting tax from taxpayers who seem willing to pay it if they are assisted in doing so, no doubt such expenditures are entirely justified. As for the minority of taxpayers who do not comply with the tax law, that group requires different treatment and that is discussed next.

2. Tax evasion arises where there is opportunity.

In order to minimise tax evasion it is important that the prospect of successfully escaping the tax net is limited. Although self assessment provides opportunity for taxpayers to pay less tax, mainly through over claiming entitlements and/or

understating income, the opportunity to successfully do so must be limited. The MIRB apparently has a good record on this<sup>65</sup> in that its audit frequency (apparently about once every 5 years) must constitute a significant deterrent to those who might be tempted to do the wrong thing but who fear the consequences of getting caught out.

Some areas of activity provide greater opportunity for evasion without detection than others. It is trite that sole proprietors who deal a lot in cash transactions that are not adequately recorded are a prime candidate for tax evasion principally by reason of the opportunities for concealment of receipts. As Vihanto puts it:

“The decision of a taxpayer to evade personal income tax typically manifests itself as undeclared earnings, perhaps from occasional sources, and as exaggerated deductions in the tax return. The best opportunities for such cheating are available in self-employed trades and professions where the income is not subject to withholding taxes and there are many warranted deductible expenses.”<sup>66</sup>

This suggests that the case is strong for (within bounds – see below) targeting such businesses with compliance checks in order to reduce opportunities for such concealment. Similarly small businesses are more prone to tax evasion than large businesses because large businesses usually rely on a wider network of respectability and honesty in order to attract clients. In short, large businesses have more stakeholders and so must be seen to be honest by a wider community.

A further opportunity for evasion arises where the law is unclear and taxpayers may legitimately take a more aggressive approach to dealing with their tax because lack of clarity in the law opens up opportunities to argue their position rather than making it very clear where boundaries lie. According to one group of researchers in the United States<sup>67</sup>

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<sup>65</sup> M. McKerchar “Self Assessment System in Malaysia – Performance to date and challenges ahead.” Address to *Tax in ASEAN and China: Regional challenges and integration conference*, ATAX, UNSW, July 2009

<sup>66</sup> Martti Vihanto, “Tax evasion and the psychology of the social contract” (2003) 32 *Journal of Socio-Economics* 111-125, 113.

<sup>67</sup> Susan Cleary Morse, Stewart Karlinsky, & Joseph Bankman “Cash Businesses and Tax Evasion” (2009) 20 (1) *Stanford Law & Policy Review* 37-68.

“One line of research, for example, indicates that a licensed tax preparer is likely to influence a taxpayer to be more aggressive on ambiguous questions and less aggressive on unambiguous questions.”<sup>68</sup>

This is a comment that sheds light on both the risks of ambiguity and on the professional alignment of some tax agents.

Not only does clarity and openness reduce opportunity for evasion it also, of course, reduces compliance costs and provides greater certainty for business as well as reducing costs of dispute between taxpayers and the revenue. These points aside however, it is evident that reducing the opportunity for successful tax evasion goes a very long way to reducing evasion itself. The steps that revenue authorities take to reduce the opportunity for evasion, however, can as has been pointed out above, lead to an outcome contrary to that which they intend. This is because an overly heavy handed approach can alienate taxpayers through a seemingly unsympathetic and overly authoritarian approach. This point will be discussed further below.

3. Tax evasion is linked to taxpayer attitudes e.g. perceptions of unfairness in the tax system.

The perception of unfairness and the effect it has on discouraging compliance draws attention to two levels of the tax system. One is probably not the province of a revenue collection authority. What is meant by this is that what the law says about who is to pay tax and what rate on what transactions or property etc is a decision to be made by government. Sometimes the revenue authority is left with the invidious task of applying laws that are seen as unfair. There is little that a revenue body can do about this other than advise government of the perceptions when they develop of unfairness held by the wider community. On the other hand how the revenue body goes about collecting tax can be influential.



<sup>68</sup> Id, 42.

The influence that a revenue authority can have is that if it treats taxpayers as honest they are more likely to behave as such. The ATO approach is along these lines with the latest tax compliance program stating that:

“The vast majority of Australians pay their tax appropriately, knowing their fellow Australians do the same. It is this confidence that is the foundation of the high levels of voluntary compliance we see in Australia. ...

In such an environment, we can differentiate our approach, minimising the intrusiveness of our compliance activities on those who want to comply, other than as a source of support, while being able to better identify those people and transactions that represent a higher risk. This is the basis of our Compliance model and risk management approach.

...we tailor our response according to their history of compliance and approach to us, individual circumstances and risk profiles.”<sup>69</sup>

The important feature, it is submitted, is that not every taxpayer is seen as non compliant and it is part of the Taxpayers’ Charter which governs the relationship between the ATO and taxpayers,<sup>70</sup> that the ATO undertakes to “treat you as being honest in your tax affairs unless you act otherwise”.<sup>71</sup>

In addition to influencing taxpayers by treating them as honest unless they are known not to be, a revenue agency should also treat the advisors to the taxpayers with respect. This is discussed next.

#### 4. Tax advisors are an important player in the tax collection process;

As has been mentioned many taxpayers employ tax agents to represent them in their dealings with the revenue authority and to assist them in completing their obligations under the tax system. This means that individual tax agents or firms of tax agents can

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<sup>69</sup> Michael D’Ascenzo Foreword to *2008/9 Compliance Program*. See <http://www.ato.gov.au/corporate/content.asp?doc=/content/00155156.htm> (accessed 19 July 2009).

<sup>70</sup> See *The Taxpayer’s Charter* <http://www.ato.gov.au/corporate/content.asp?doc=/content/25824.htm> (accessed 19 July 2009).

<sup>71</sup> Item 2 *The Taxpayer’s Charter*.

be responsible for the compliance, actions and overall integrity of substantial groups of taxpayers. The reference to Australia, above, indicated that in 2005 well over half of the active tax agents in the system had over 100 client taxpayers. Large firms, especially large international firms of accountants can represent immense numbers of clients in the highest tax paying group. They are thus very important to the efficient running of the tax system. They should therefore be controlled on one level but accommodated understood and consulted on another. The ATO in Australia claim to do all of these things. The constraints imposed on the profession by the system of registration of tax agents and the ability to remove tax agents who do the wrong thing have been identified above. Similar constraints on tax agents are discussed in the IRB's own *Tax Audit Framework* publication which sets out the expectations of taxpayers' representatives in the context of an audit. Notable amongst those in the prohibition on tax agents of: "Giving wrong advice to taxpayers and collaborating with taxpayers to avoid paying the correct amount of taxes;"<sup>72</sup>

At another level, however, the tax agent works for the revenue authority in encouraging compliance by taxpayers and thus has been endowed with a high level of trust. This makes them, in a sense, a representative of and assistant to the revenue collection agency. The ATO appears to recognise this. Stating that "Consultation and research with and feedback from tax professionals and professional bodies is essential for understanding how the tax system is operating in practice and to make improvements to how we administer it so as to minimise compliance costs and provide a level playing field."<sup>73</sup>

Apparently the ATO used opportunities to consult with the tax professionals to identify problems with, and smooth out aspects of tax administration. They state that in the 2007/8 year they "...worked with some 900 tax practitioners on consultation and co-design projects and invited 3,700 tax and accounting professionals and 2,000 bookkeepers to participate in our surveys. Through ...[their] consultative forums a

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<sup>72</sup> Subparagraph 8.3.5.1 *Tax Audit Framework* 2009 Amendment.

<sup>73</sup> *ATO Compliance Program 2008/9*, "Working with the tax profession" at <http://www.ato.gov.au/corporate/content.asp?doc=/content/00155156.htm&page=75&H75> (accessed 19 July 2009).

significant number of issues have been managed...”<sup>74</sup> It is submitted that a close working relationship between the revenue collection agency and tax practitioners will serve to increase the levels of trust between the two and result in a better working relationship that is more cooperative and less adversarial and contribute to greater levels of compliance and integrity generally. Revenue authorities cannot, however afford to forget who it is that the tax agents work for and that is for their own clients. It must be remembered that tax advisers owe a duty to legally minimise the tax paid by their clients.

Certainly it is the case in Australia that a high level of professionalism and quality advice to their clients is expected of tax professionals. There are several cases in Australia which suggest that the onus of professional care on tax advisers is high. In *Carmody v Priestley & Morris Perth Pty Ltd*<sup>75</sup> an Accountant was found to be negligent in not warning a client that the method of financing a certain property purchase would result in a tax liability under deemed dividend anti avoidance rules. This was held to be the case even though the practitioner was not directly asked for advice on this. In *Bell v Vahexi Ltd*<sup>76</sup> it was no defence to a negligence claim by a client that the small accounting firm was unaware of new and complex thin capitalisation rules which denied the client deductibility of certain expenditure resulting in loss to the client. It was expected, in the application of his client, that the accountant would “...advise ... of structures and methods by which the respondent's liability for income tax would lawfully be minimised.” The court made no finding contrary to this.

In light of the heavy professional obligation on advisers to serve the interests of their clients rather than those of the tax system it should be borne in mind by revenue authorities that they are not the only stake holder to which obligations are owed by representatives of taxpayers. This should temper any attitudes in the revenue which foster disrespect for tax professionals on the basis that they aid and abet clients in avoiding tax. It should not be expected, nor tolerated, however, that tax professionals assist taxpayers in evading tax because evasion involves either their own dishonesty

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<sup>74</sup> Id at <http://www.ato.gov.au/corporate/content.asp?doc=/content/00155156.htm&page=77&H77>. (Accessed 19 July 2009).

<sup>75</sup> *Carmody v Priestley & Morris Perth Pty Ltd* [2005] WASC 120.

<sup>76</sup> *Bell v Vahexi Ltd* 40 ATR 459.

or the condonation of their clients' dishonesty and could well amount to both a criminal offence and an act that breaches the professional ethical code applicable to the tax professional. In the event that the relevant code does not cover such actions then it is open to the government to legislate in the context of the code that governs the relationship between the tax profession and the revenue collection agency in such a way as to introduce a sanction against the action by the tax professional which assists evasion but is not automatically or obviously within reach of some existing sanction whether criminal or otherwise. This would be a legitimate use of government's power to regulate the tax collection process and relevant relationships.

## **Conclusion**

This paper has described a tax compliance environment that is as complex as society itself. Research seems to suggest that taxpayer integrity relies on a complex web of influences and factors not all of them within the control of a collection agency. Indeed some are rooted in the human condition and fuelled by natural greed, envy, and basic social relationships. Yet the revenue collection agency must attempt to influence, support, guide and coerce taxpayers to comply and must do so with all sensitivity for the relevant influential factors. It is said that the French Minister to Louis XIV, Jean Baptiste Colbert, once said that "The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing"<sup>77</sup> such is the unenviable task of the revenue agency. It has to be strong and not give in to pressure groups, but also be flexible and understanding and not treat all taxpayers as if they are non compliant. This is a delicate balance requiring constant reflection and moderation and attention to detail as well as sensitivity to the legitimate claims of the community. Sadly, such is this task that it will seldom be possible to say, without doubt, that it has got things exactly right. It is probably certain, however, that should all the geese take fright and hide or flee there will be no feathers to pluck.

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<sup>77</sup> It is uncertain where this is sourced but the quotation is widely used. See for example <http://thinkexist.com/quotation/> (accessed 20 July 2009).