

**Australian Government****Australian Taxation Office**

## **Identification and Registration of SMEs and Methods to Reduce the Informal Economy – an Australian View**

The informal economy presents endemic and complex risks for most countries. Governments and tax administrations are looking to better understand its drivers and to implement mechanisms to mitigate it. Australia is no exception.

Across jurisdictions, there is no commonly agreed definition of the informal economy. Terms such as 'underground', 'grey', 'black', 'hidden', 'shadow' and 'cash' economy are used by jurisdictions around the world to describe economic activity which is not accounted for as required by law. Irrespective of the definition used however, all taxation administrations face some similar issues when dealing with the informal economy.

The risk presented by the informal or cash economy, as it is recognised by the Australian Taxation Office, is endemic and requires a continued response. In doing this, it is important to demonstrate to the community that the response is the right one. Studies consistently support a high incidence of informality and unreported income by small, cash-based businesses. This is influenced by a number of factors. These include costs of compliance; limited understanding of tax laws; opportunities to under report and, in some instances, fraudulent behaviour.

This paper describes the impact that the design of the Australian tax system has on the registration of businesses in the system and on the cash economy. It also discusses the cash economy compliance journey in Australia; what has worked recently; some challenges encountered along the way and where we plan to place emphasis for the immediate future.

### **THE AUSTRALIAN TAX SYSTEM**

Since 1986-87, Australia has had a system of self-assessment of income tax. 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 that are managed by balancing our resources and structuring ourselves to ensure that we optimise the level of voluntary compliance.

Self-assessment also means a tax system supported by a Taxpayer's Charter. This requires that we are open and fair in our treatment of people, within the framework set by the law. The Charter sets out our commitment to inform people of their rights, obligations and entitlements and directs the way we behave towards the community. It states what the community can expect from us. The 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 (collected by the Australian federal government on behalf of State and Territory governments), superannuation and excise. The Australian Taxation Office also administers a range of benefit and refund payments, including the baby bonus<sup>1</sup>, income tax and goods and services tax (GST) refunds, excise grants, family tax benefits, and superannuation guarantees.

- Income tax is the largest of the revenue products that we administer. It includes personal tax, company tax, capital gains tax and taxation of superannuation funds. Income tax is the largest source of federal revenue, accounting for around 75% of total revenue collected in 2006–07. GST accounted for about 15% of total revenue, while excise on alcohol, tobacco and petroleum accounted for about 10%.<sup>2</sup>
- We play a significant role in administering the superannuation system, which now has more than \$A1 trillion 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.

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.

In the 2005-06 financial year, the Tax Office collected \$A232.6 billion<sup>3</sup>. This included collections exceeding \$A37.4 billion in goods and services tax for State and Territory governments.<sup>4</sup>

The Australian Taxation Office employs approximately 21,500 employees in offices all around Australia. Around 470 employees work specifically on managing the cash economy risk.

## **SMALL TO MEDIUM ENTERPRISES (SMEs) IN AUSTRALIA**

Australia recognises that there is no single internationally accepted definition of what constitutes a small to medium enterprise. Tax administrations around the world use a variety of measures and thresholds when defining a small to medium enterprise. Many use employee numbers, annual turnover, asset thresholds, or some combination of these measures.

In Australia, 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:<sup>5</sup>

- Individuals
- Micro Enterprises (annual turnover under \$A2 million)
- Small to Medium Enterprises (annual turnover \$A2 million - \$A100 million<sup>6</sup>)

<sup>1</sup> The baby bonus is a payment from the Tax Office for eligible people who had a baby or gained legal responsibility for a child aged under five, between 1 July 2001 and 30 June 2004.

<sup>2</sup> Australian Taxation Office, *Compliance Program 2007-08*, 2007 pg 4

<sup>3</sup> Australian Taxation Office, *Annual Report 2005-06*, pg v

<sup>4</sup> Australian Taxation Office, *Annual Report 2005-06*, pg iv

<sup>5</sup> Australian Taxation Office, *Compliance Program 2007-08*, pg 7

- Large Business (annual turnover above \$A100 million)
- Non-profit organisations
- Government organisations

While each jurisdiction may have a slightly different definition of micro business and small to medium enterprise clients, we all share a desire to encourage these entities to engage with the tax system. We strive to provide them with the information and assistance they require to understand their obligations and tailor our compliance approaches accordingly when they fail to do so.

There are around 2.5 million micro businesses within Australia, and more than 120,000 small to medium enterprises. Around 96% of all businesses in the Australian revenue system are micro businesses. Certain industries dominate the business sector in Australia. 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. Despite their large numbers, their small turnover means that the tax paid by micro businesses is only 11% of total tax collected.

More than 85% of small to medium enterprises have an annual turnover of less than \$A10 million. Around 92% of these businesses are privately owned. Many are part of larger groups controlled by one or a few individuals. The tax paid by small to medium enterprises is a further 11% of the total tax collected in Australia.

## IDENTIFICATION AND REGISTRATION OF BUSINESSES IN THE TAX SYSTEM

In the year 2000, *A New Tax System* was introduced in Australia. This is the legislative platform that supports a goods and services tax (GST), which is similar to the value added tax (VAT) in other jurisdictions. GST is a broad-based tax of 10% on the supply of most goods and services.

### Registration integrity measures in the new tax system

The new tax system design included a number of measures that improved the registration of businesses in the tax system, namely:

- Australian Business Number (ABN) - a unique identifier for entities that carry on an enterprise - including individuals. It is also used across a range of government agencies.<sup>7</sup> It was based on the principle of the Tax File Number, which is a unique identifier for each Australian taxpayer.
- Goods and Services Tax (GST) Registration - compulsory where business turnover is greater than \$A75,000 per annum, for all participants in the taxi industry, and for charities with a turnover greater than \$A100,000.
- Australian Business Register (ABR) - a public register that can be used to check business information, including GST registration and ABN validity.

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<sup>6</sup> The Australian Taxation Office is in the process of re-categorising the SME market by increasing the upper turnover limit to \$250 million. (*Compliance Program 2007-08*, pg 26)

<sup>7</sup> All entities carrying on an enterprise are entitled to register for an Australian Business Number, and all companies regardless of their activity.

- 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 - regular self-assessed reports, which are filed with the Tax Office, summarising an entity's activities for the period and tax consequences.
- No ABN tax withholding - occurs if a supplying business does not quote its Australian Business Number in a business to business transaction. The paying business must withhold 46.5% of the amount payable, and remit this amount to the Tax Office.

The interaction of the ABN with no-ABN withholding and tax invoices encouraged businesses that may have previously operated outside the system to register. Businesses that are registered (and have an ABN) are reluctant to deal with businesses that do not have an ABN. They do not wish to bear the compliance costs associated with withholding part of the payment and remitting it to the Tax Office. Similarly, businesses that are registered for the GST are reluctant to deal with unregistered businesses because in some instances, although the gross cost of their purchase may be cheaper (because the cost does not include GST) the transaction must be treated as an exception in their accounting systems with associated cost of compliance. Depending on the situation the reverse can also be true - unregistered businesses cannot claim GST input tax credits on their purchases. Where this occurs they tend to inflate their selling prices to recover the equivalent of the credit from their customer; another reason for registered businesses to be wary.

As a result of the introduction of these measures, many businesses that had previously operated outside of the taxation system entered it for the first time. The number of entities registering for an ABN exceeded expectations.<sup>8</sup> There was also a significant increase in individual tax file number (TFN) registrations, a TFN being a pre-requisite for an ABN.<sup>9</sup> Many businesses that had not filed taxation returns for some time re-engaged with the tax system.

The Cash Economy Taskforce reported in 2003 that, "Since the start of the new tax system over \$A135 million has been withheld from businesses that did not quote a valid ABN when supplying goods or services" and "more ABN registrations were received than initially expected, with tens of thousands of businesses previously outside the system drawn in. Those with unmet obligations from previous years are now being pursued ..."<sup>10</sup>

An issue that has emerged has been the cost of compliance for business. While this is not a new issue as such, the introduction of the above measures, especially the need for most businesses to file a business activity statement exacerbated the issue for many small business owners. Over the past seven years the Tax Office has been working more closely with Tax Practitioner representative bodies to reduce the time and money businesses need to spend to comply with their various obligations. This has included initiatives to reduce costs by offering more services on-line through our Tax Agent and Business portals on our website, for example, the facility to support registration for GST and submission of business activity statements for expedited processing.<sup>11</sup>

<sup>8</sup> Cash Economy Taskforce report, *The Cash Economy under the New Tax System*, September 2003, pg 8

<sup>9</sup> Prior to the introduction of the goods and services tax, a TFN was the client identifier. It remains the client identifier for other taxes, most notably income tax.

<sup>10</sup> Cash Economy Taskforce report, *The Cash Economy under the New Tax System*, September 2003, pg viii

<sup>11</sup> Australian Taxation Office, *Annual Report 2005-06*, pg 59

One unforeseen consequence of making it easier to comply is that we have a large number of voluntary registrants in the system, that is, people who have no requirement to be registered for GST. While this is good from one point of view, it also has created the opportunity for GST fraud and other negative impacts. Our goal is to keep registrations to those who need to be in the system. Balancing the cost of compliance for business and some of these unintended consequences remains a challenge into the future.

### **Identification of businesses outside the system**

Despite the measures outlined above, there will always be those who attempt to operate outside the system. The Tax Office adopts a number of strategies to try to identify these businesses and register them in the system, including:

- conducting unannounced visits to business premises (particularly in shopping centres) to check that the business has an ABN;
- checking the validity of tax invoices to ensure the supplier has a valid ABN and is registered for the GST; and
- matching the ABR against income tax records to identify businesses that have not filed tax returns.

These strategies are successful in identifying businesses that are un-registered and have not filed income tax returns for many years. Cases are followed-up to ensure returns are demanded and income reported.

## **THE AUSTRALIAN TAXATION OFFICE COMPLIANCE APPROACH**

Before discussing our compliance approaches in the cash economy, it is important to understand the general compliance approach used by the Tax Office.

As the Australian system is based on self-assessment and voluntary compliance, an active and targeted compliance approach is necessary. Generally, taxation compliance within Australia involves four key obligations:

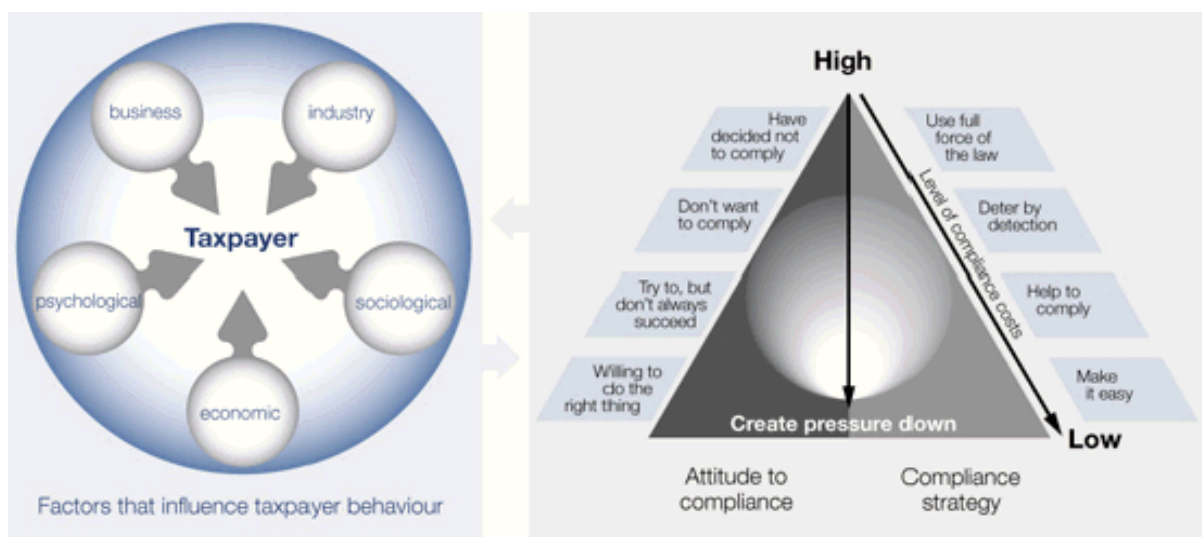
- registration
- filing
- accuracy of information filed, and
- payment.

Compliance anticipates that all four obligations are to be met.

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. At the same time we have strategies to deter, detect and address non-compliance.

A balance is sought between verification and enforcement activities (e.g. audits, risk reviews and prosecutions), providing assistance (e.g. education and advice), and making it easier to comply (e.g. pre-populating electronic tax returns with information relevant to the individual taxpayer – such as details of interest or dividends received). These strategies are based on a compliance ‘pyramid’ common to many regulatory regimes. The Australian Taxation Office’s Compliance Model directs that we better understand why people are not complying, and that we develop appropriate and proportionate responses. Many factors such as business, industry, sociological, economic, and psychological influence whether a person chooses to meet their obligations.

### The Compliance Model



The model depicts a continuum of taxpayer attitudes to compliance: from taxpayers who are 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 base of this pyramid.

Compliance strategies should be commensurate with a taxpayer’s willingness to comply. A range of graduated compliance products and approaches are used, which are intended to create downward pressure and increase this willingness to comply. Accordingly, initial action begins with self-regulation strategies like education, record keeping and assistance. Where a taxpayer makes an honest mistake, or takes ‘reasonable care’ or has ‘a reasonably arguable position’ we have a penalty regime where a penalty (like interest) is charged at a lesser rate or is remitted at the Commissioner’s discretion.<sup>12</sup> Enforcement strategies are designed for those displaying a deliberate intention not to comply.

<sup>12</sup> Australian Taxation Office, *Report on Aspects of Self-Assessment*, August 2004

## The Compliance Program

First released in late 2002, the *Compliance Program* has emerged as the main vehicle used by the Australian Taxation Office to communicate its cash economy strategy and activities to small business, tax practitioner and wider communities. The Program provides an annual outline of the Tax Office's compliance strategies in relation to all taxation compliance risks, including the cash economy.

The aim of our compliance program is to identify areas of risk and explain how we intend to respond, as well as outlining a wide range of measures to help those people trying to comply. Our compliance program is driven by risk, which informs how we allocate our limited resources. While we have many programs in place to interact with the community and to encourage voluntary compliance, we also need to apply the force of the law when people wilfully seek to abuse the system.

To minimise numbers of inappropriate registrations for Australian Business Numbers, we regularly review those that do not appear to represent active businesses. Using a set of risk criteria, identity documents are selected for closer examination, in some cases, before issuing Tax File Numbers. To prevent these numbers being used for fraudulent purposes, redundant registrations are cancelled where taxpayers are deceased or known to have left the country. At a broader level, the Tax Office works with other government agencies to combat identity related tax fraud.

To identify businesses that pose the highest risk of not filing returns or of filing late, we compare information from internal and external sources and tailor our response to the level of risk and the compliance history of each business. Failure to file tax returns is addressed by contacting taxpayers by letter or phone; undertaking field reviews; referring taxpayers for prosecution; making assessments based on available information and, where necessary, imposing statutory penalties and taking prosecution action. There is also a leveraged approach to influence behaviour through tax agents and representative bodies.

Filed returns are subjected to risk-based analysis to identify those populations with a high probability for income omission. At a broad level, we undertake risk profiling – analysing information in returns and from third parties to identify risk characteristics among taxpayers (such as patterns of transactions). Verification activities involve:

- building risk profiles – identifying risk characteristics among groups of taxpayers (such as particular patterns of transactions) by analysing information we collect in returns and from third parties such as financial institutions, government agencies and auditors of self managed superannuation funds.
- data matching and applying risk profiles to taxpayers – identifying inconsistencies, unreported transactions and other risks by automatically checking returns against taxpayers' past behaviour and data from sources external to the Tax Office.
- reviewing specific taxpayers where we identify inconsistencies or other risks.
- auditing taxpayers where reviews confirm the risk.

Taxpayer returns (including activity statements and other reports) are the foundation for verifying compliance. This is why we put emphasis on the requirement for taxpayers to file returns in full and on time.

When risks are identified, our contact with taxpayers depends on the nature and complexity of the risk. It typically starts with letters and phone calls seeking more information or clarification, and extends to field visits and audits where required. Risk profiling is as much about identifying taxpayers who represent little or no risk to the tax and superannuation systems, so that we can leave them alone, as it is about identifying non-compliance.

## MANAGING COMPLIANCE IN THE CASH (INFORMAL) ECONOMY

### The cash economy in Australia

There are various estimates of the size of the cash economy in Australia, with a wide degree of variability. The Australian Bureau of Statistics (ABS) estimated the cash economy was approximately 2% of gross domestic product in 2000–2001.<sup>13</sup> (Although some estimates from other sources do vary from this figure.)<sup>14</sup> The cash economy could exist across all markets to a greater or lesser extent, but as mentioned earlier in this paper, in Australia it predominately exists in the micro business and lower end of the small to medium enterprise markets.

### Factors that influence cash economy participation

Many factors can influence the tendency of a taxpayer to participate in the cash economy. Some are common to all taxation jurisdictions and others are more specific to individual countries. There are a number of long term trends in the growth and make up of the Australian population including:

- influence of migration/cultural issues
- aging of the workforce
- growing numbers of retirees
- increase in workplace participation by women
- population shift towards cities.

The potential effect of these trends on participation in the cash economy is hard to discern and may not always be obvious or expected. For example, the increased participation by women in the workforce, results in more house work being outsourced, particularly food preparation and cleaning.<sup>15</sup> Growth is also evident in expenditure at cafes and restaurants, from 5.7% of all household spending in 1998 to 6.7% in 2006 and household spending on domestic services had doubled in the last five years.<sup>16</sup> These are business types normally associated with the cash economy.

The concentration of population distribution into large cities (and certain coastal regional centres) and consequential sparse rural populations contribute to a variety of different cultural, social and environmental norms which are influenced and reflected by government policies especially in relation to tax compliance, social welfare and environmental issues.<sup>17</sup>

<sup>13</sup> Australian National Audit Office, *Audit Report No.30 2005-2006*

<sup>14</sup> Most notably - Bajada, C and Schneider, F, *Size, causes and consequences of the underground economy*, Ashgate Publishing, Canberra 2004

<sup>15</sup> Wade, Matt "Market Does the Work That Men Won't" Sydney Morning Herald. 1 Nov 2006

<sup>16</sup> Wade, Matt 1 Nov 2006, *ibid*

<sup>17</sup> Australian Bureau of Statistics, *3218.0 Regional Population Growth Australia 1996 to 2006*, July 2007: Most population growth is occurring in the inner city and outer suburbs, with a corresponding decline in rural areas – most

The wide range of cultural backgrounds may contribute to varying attitudes to compliance with taxation laws, especially where the countries of origin have significantly different social regimes and tax treatment.<sup>18</sup>

The retirement population is a growth segment of the Australian community.<sup>19</sup> Since 1995, Australia's resident population aged over 45 years has increased by 30%, but the number of children has only grown by just 2.3%.<sup>20</sup> By 2050, approximately one quarter of the population is likely to be retirees. This unbalanced growth reflects the gradual aging of the population, which inevitably impacts on labour market supply, financial products for retirees and the income support policies of government.

In Australia, the use of superannuation products and compulsory superannuation has existed for less than two decades and while over 90% of those intending to retire in the next five to fifteen years have contributed to a superannuation product, this demographic is likely to enter retirement with a more modest income than they are used to.<sup>21</sup> This scenario of decreased income presents two primary concerns for the Australian Tax Office within the cash economy segment:

- Small business may increase cash economy activity to increase retirement savings; and
- Asset and earnings tests for Government aged pensions and concessions create an incentive for retirees seeking additional income to enter the cash economy.

A 2004 study concluded from survey results that most Australians will use cash for transactions involving less than \$A50.<sup>22</sup> Other research suggests that the cash economy risk is concentrated in both low value retail transactions and also in high value household services, where a cash discount is attractive<sup>23</sup>.

Research also shows other commonly occurring dimensions to the cash economy participant:<sup>24</sup>

- often family run businesses;
- more likely than not to own rental properties or other investments;
- have usually been in business a number of years;
- are likely to provide auditors with incomplete records; and
- the majority have their income tax returns and their business activity statements prepared by a tax agent.<sup>25</sup>

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notably those areas affected by drought. The main exception to this pattern is the growth in certain regional centres, particularly on the eastern coast of Australia.

<sup>18</sup> Although this is not reflected universally in the research – per: Bajada, C and Schneider, F, *Size, causes and consequences of the underground economy*, Ashgate Publishing, Canberra 2004

<sup>19</sup> World-wide, we have the fourth highest life expectancy.

<sup>20</sup> Australian Bureau of Statistics 6238.0 - *Retirement and Retirement Intentions Aug 2004 - Jun 2005*, July 2006, p2

<sup>21</sup> Australian Bureau of Statistics 6238.0, *ibid*, p7

<sup>22</sup> Bajada, C and Schneider, F *Size, causes and consequences of the underground economy*, Ashgate Publishing, Canberra, 2004

<sup>23</sup> Bajada, C and Schneider, F *Size, causes and consequences of the underground economy*, Ashgate Publishing, Canberra, 2004

<sup>24</sup> Bajada, C and Schneider, F *Size, causes and consequences of the underground economy*, Ashgate Publishing, Canberra, 2004

<sup>25</sup> In Australia, these are the two returns filed for the income and goods and services taxes respectively.

Much of the cash economy is opportunistic - participation occurs simply because the opportunity to do so exists. Businesses where cash transactions are common are more likely to engage in the cash economy. However, some participants in the cash economy do so in a planned and deliberate manner, using entity structures and business systems to facilitate this.

In 2004, the Australian Taxation Office commissioned research into community norms and personal behaviour in relation to the cash economy.<sup>26</sup> The research found that:

- people did not think a great deal about the cash economy.
- when they did think about the cash economy they did not necessarily see it as a bad thing.
- negative cash economy perceptions were typically directed at the minority who 'overused and abused' the system, to the detriment of other individuals and society in general.

In light of these results, the Tax Office has a challenge to make the cash economy more of an issue for the community and to emphasise its negative aspects. An increased awareness of the potential consequences for consumers and suppliers is also required.

### **Optimising voluntary compliance in the cash economy**

In November 1996, the Commissioner of Taxation established the Cash Economy Taskforce to examine the cash economy in Australia, determine the compliance issues involved and recommend additional steps the Tax Office could take to improve compliance.

The Task Force was established against a backdrop of increasing community concern about escalating cash economy transactions and evasion.<sup>27</sup> Task Force reports in 1997 and 1998 imparted a sense of urgency that the Tax Office establish a greater presence in the community via the development of a community awareness/education campaign outlining the costs to the community of tax evasion and that tax evasion was a crime.<sup>28</sup> The Tax Office acted on these recommendations with an increase in cash economy specific community education and advice, compliance measures and targeted research and intelligence gathering.

Despite targeted efforts to inform the community of action taken to address the cash economy, low community awareness continued. Feedback obtained from research conducted with both the business and the general community over the past five years, has highlighted that a considerable proportion of taxpayers remain unaware of the Tax Office's efforts to address cash economy activities.<sup>29</sup> As previously mentioned, not all Australians view the cash economy as a bad thing.<sup>30</sup> These community views can only be modified if the cash economy becomes more of a negative issue for the community and the community believes participation in the cash economy would result in significant consequences.

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<sup>26</sup> Blue Moon Research and Planning 2004, *ATO: Cash Economy Community Research – Qualitative Research Report*, May

<sup>27</sup> During the period 1997 through to 2003, the Cash Economy Task Force released three reports - Cash Economy Task Force, *Improving Tax Compliance in the Cash Economy*, May 1997; *Improving Tax Compliance in the Cash Economy*, April 1998; *The Cash Economy under the New Tax System*, September 2003

<sup>28</sup> Cash Economy Task Force, *Improving Tax Compliance in the Cash Economy*, pp 1-3, 19, 30-31, 1997; *Improving Tax Compliance in the Cash Economy*, Executive Summary, pp 28-29, 50-51, 1998

<sup>29</sup> Australian Taxation Office, *Community Perceptions Survey 2003-2006; Business Perceptions Survey 2004-2007*

<sup>30</sup> Blue Moon Research and Planning, *ATO: Cash Economy Community Research – Qualitative Research Report*, pp 5, 7, 22, 24, 28, May 2004

A range of marketing and education initiatives have been used in recent years to provide easy access to information and to encourage voluntary compliance. These initiatives have included:

- campaigns publicising requirements to be registered. These were used intensively in the first three years following the tax reforms introduced in 2000. This was successful in bringing people into the tax system by encouraging registration for Australian Business Numbers;
- publications such as those that provide advice on the requirements for registration for the goods and services tax. Publications are available via the internet as well as in hard copy from Tax Office enquiry points and other government agencies that support small and medium sized businesses;
- seminars that cover a wide range of tax topics for businesses – particularly those people that are new to business;
- regional and remote business organisations are contracted to facilitate the exchange of information between the Tax Office and their members and clients;
- liaison with other Government departments involved in business registrations (i.e. Consumer Affairs), with some educational initiatives providing concurrent access to a range of advice from multiple government departments; and
- products have also been developed to address the specific needs of certain community sectors including: seminars for new business immigrants; foreign language publications; and culturally based media releases.

However, a key issue that remains 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:<sup>31</sup>

- 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 those collected from customers and employees as well as those of the business itself;
- Invoicing, including inaccurate invoicing procedures or the correct breakdown of the payment for GST purposes; and
- Inaccurate use of the Australian Business Number, including not using a valid number, using it in inappropriate circumstances and not withholding from a business when no ABN is quoted.

These problems often arise due to a lack of understanding and low skill levels, rather than any deliberate intention not to comply. The new tax system has brought with it new opportunities for the detection and evaluation of risk. With more business entities now registered and filing business activity statements, the Tax Office has a rich data source for identifying businesses with unusual trading patterns. The Tax Office approaches its strategy development on the basis that the vast majority of businesses within industries with the cash economy wish to be compliant and as such strategies of encouragement and assistance applicable to the lower end of the compliance model are required to address the issues.

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<sup>31</sup> Cash Economy Task Force, *The Cash Economy under the New Tax System*, September 2003, pg 17

Record keeping is recognised as closely associated with cash economy participation and consequent non compliance with tax obligations. To address poor record keeping the Australian Taxation Office provides:

- free record keeping software. *e-Record* is the Tax Office's free electronic record keeping software for business. *e-Record* helps small businesses (including non-profit organisations) to keep good business records and meet their taxation reporting obligations. Businesses can also lodge their activity statement online using the facilitated filing feature in *e-Record*.
- public education seminars;
- a free Record Keeping Assessment Tool - an interactive program that helps small businesses understand what business records they need to keep. It will also help evaluate how well the business is keeping its records; and
- fact sheets for several specific sectors (retail, service, wholesale and primary production) outlining the basic record keeping requirements.

In addition to connections with the general community, the Tax Office has also sought to build links with industry and business associations. In 1999, the Tax Office set up a series of consultative industry forums with a selection of key industry groups, many of which were industries with higher cash economy participation. These industry partnerships were one of the key links in implementing the new tax system and have a continuing role in our on-going relationship with the business community.

### **Compliance approaches in the cash economy**

The foundation for the Australian Taxation Office's current focus is the recommendations made by both the Cash Economy Task Force and the Australian National Audit Office in recent reviews of Tax Office approaches to the cash economy risk. Along with other recommendations, both identified a need to better address business to consumer transactions. Some other suggestions are that:

- case selection should be risk driven;
- shift should be made from an industry focus to a broader one recognising particular behaviours;
- focus should include both transactions between businesses and also those between business operators and consumers; and
- focus should be given to the non reporting of income as well as registration and filing risks.

The Tax Office has realigned its approach to managing intelligence and risk in recent years. This has had a consequent effect on risk identification, assessment, treatment and case selection processes. Intelligence and risk processes are in place to collect, analyse and report existing and emerging cash economy risks.

While the cash economy is not restricted to particular industries, there are a number of industries where there is a high concentration of cash transactions. Until recently, cash economy compliance activities were managed from an industry perspective. This approach concentrated on industries that historically have presented opportunities to engage in high volume cash transactions, such as the construction and retail sectors.

Traditionally, the Tax Office's Compliance Program recognised high risk industries with a broad range of compliance responses directed to all risks within those industries. These would include registration, filing, correct reporting and correct payment risks. Industries which we previously identified as high risk for cash economy involvement included:

- property, building and construction
- second hand motor vehicle wholesaling and retailing
- restaurants, cafes and takeaway food outlets
- licensed hotels and registered clubs
- horse racing, breeding and thoroughbred exports
- fishing
- adult goods and services
- hairdressing and beauty
- taxi services
- cleaning services
- road freight
- security services

The industry approach and associated strategies were designed to deliver a range of compliance responses. These included leveraged approaches to relevant groups of taxpayers engaged within the tax system. At the other end of the spectrum they extended to specific audit responses and sanctions for those individuals who present a disengagement risk. This range of responses continues in use and audits remain a significant component of our compliance efforts.

However, as mentioned earlier, the range of integrity measures which were introduced as part of the new system, have led to high voluntary compliance in connection with *business to business* transactions. Businesses tend not to deal with other enterprises outside the system.

In 2006-07 the Australian Taxation Office changed that way it defined the cash economy, from a revenue system viewpoint, to place real focus on non-reporting behaviours:

*"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."*

This change continues to reshape our thinking and the scope of our cash economy response. It focuses us on the risk of non-reporting of cash transactions. Greater emphasis is now being given to behaviours, attitudes and specific characteristics which are indicators of cash economy participation. Particular trades and activities within industry groups are still examined where appropriate. The main objective of cash economy compliance activity is still to maximise participation in the system.

The opportunity to evade the obligation to report cash income has two prerequisites, the first being access to cash. Typically, this exists where businesses transact a significant volume of activities for cash or have the opportunity to convert part of their income to cash. The second element relates to opportunity. Most businesses have controls to ensure that all sales are recorded. In larger businesses, ownership and stewardship are separated. There are controls in place to ensure that employees do not misappropriate cash. The cash economy risk most commonly occurs where the person evading tax, generally the business owner, controls some part of the cash recording and handling processes.

In addition to this business view, individuals also feature in the cash economy. There are two main ways in which this occurs:

- as suppliers of labour for cash wages from which no income tax is deducted by the employer, and which is unreported by the employee; and/or
- as purchasers of goods or services for cash, with or without the implied expectation that the supplier would not report or pay tax on the supply. Typically, no records issue for these *business to consumer* transactions.

Cash dealings are a fundamental and legitimate component of the Australian economy. Cash is regarded as a reliable store of value and as a highly convenient medium of exchange. A recent examination suggests:

- 75% of Australians use cash for transactions less than \$A50.
- Family run businesses that have been operating for a number of years, often keep poor or limited records.
- Non-compliance is higher in *business to consumer* transactions and is driven by competition, low margins, customers in search of discounts, as well as tax advantages sought by the business owners.
- Participants in the cash economy have a low perception of their unreported income being detected.
- Participants may also believe that their behaviours are justified by the perceived inequities in the taxation system. When it comes to taxation, the community perception of what is fair and equitable differs to the Tax Office view.<sup>32</sup>
- The community appears to accept a certain level of cash economy behaviour, however is less tolerant if the offender is a recipient of Government welfare benefits.

### **Our compliance approach for 2007-08 and beyond**

The intent of compliance risk management in the Australian Taxation Office is to use our available resources in the most efficient way. This means that risks are prioritised and our treatment approaches directed to the highest risks. Reflecting the priority given to our cash economy program, we have around 470 officers immediately responsible for managing the cash economy risk. Across the Tax Office, there are significant numbers of other officers; we estimate around 2,000, who also contribute to our cash economy efforts as part of other recognised compliance responses.

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<sup>32</sup> Australian Taxation Office, *Community Perceptions Survey 2006*

Typically, the compliance risk in the cash economy involves businesses or individuals under-reporting or not reporting cash income or cash surrogates (for example, through barter activities), or transactions subject to GST. In 2007–08 the Australian Taxation Office will address behaviour that is typical of individual cash economy participants, and pay more attention to *business to consumer* transactions.

This year, while continuing to address *business to business* interactions, the Tax Office will be giving increased attention to cash transactions between business operators and consumers. It has developed a number of approaches that will continue to demonstrate to the community the Tax Office's response to the cash economy. These approaches acknowledge community attitudes and concerns, as the participation and assistance of the community is sought in shaping our responses.

The Tax Office will continue to review industries where cash transactions are significant and present opportunities for widespread non-compliance. There will however, be additional focus on addressing behaviour and attributes that are typical of individual cash economy participants.

This year, we plan to contact approximately 36,500 businesses regarding potential cash economy issues. Activities will include compliance letters, unannounced visits, activity statement reviews and audits.

We will also be undertaking a range of pilot activities intended to add to current approaches to the cash economy. In part, these activities recognise and respond to the compliance risk associated with *business to consumer* cash transactions. These pilot activities relate to six key areas of cash economy risk or opportunity:

Project	Project Focus and Aims
Benchmarking	<p>To test our ability to influence community confidence by being seen to focus on those the community perceives as the more visible elements of the cash economy; thereby increasing confidence that the Tax Office is addressing cash economy risks.</p> <p>By publishing trade endorsed benchmarks, expressed in terms of the relationship of inputs to reported income, we are able to provide confidence to compliant business taxpayers and identify those who are high risk for potential omitted income.</p>
Third party data	<p>To use data from a range of sources external to the Tax Office to identify omitted cash income received in business to consumer transactions. The focus will centre on specific data sources in the retail and construction industries.</p>
Information received from the community via our <i>Tax Evasion Hotline</i>	<p>To improve our use of community information about possible tax evasion in a manner that instils confidence that the Tax Office:</p> <ul style="list-style-type: none"> <li>▪ Treats information received from the community seriously;</li> <li>▪ Values and responds to information received;</li> <li>▪ Takes action in relation to non compliance brought to the Tax Office's attention;</li> <li>▪ Is able to appropriately address the cash economy.</li> </ul>

Project	Project Focus and Aims
Conspicuous consumption	<p>To increase community awareness that the Tax Office is tackling what the community perceives as the least acceptable elements of the cash economy - taxpayers who aggressively exploit the system and display this success in the lifestyle they lead. Typically, these taxpayers will have access to large amounts of cash through their business activities, lead a wealthy lifestyle and have reported income that is inconsistent with this wealth.</p> <p>We anticipate that a characteristic of this cash economy participant is that they are likely to lead a conspicuously wealthy lifestyle by purchasing goods and services such as luxury cars, boats, and properties (including expensive renovations) and by taking regular overseas holidays. Their non-compliance is likely to be so flagrant that prosecution would generally be considered.</p>
Non-compliance with multiple obligations	<p>To test impact on community confidence through being seen to focus on those the community perceives as the least acceptable elements of the cash economy and thereby increase community confidence that the Tax Office is addressing the cash economy.</p> <p>A common characteristic of this unacceptable cash economy participant is that they are likely to be non compliant in connection with more than one government obligation. For example, taxation, fair trading practices, industrial relations, immigration, government welfare support, superannuation, record keeping requirements, copyright infringement and workers compensation insurance.</p>
Measuring effectiveness	<p>This project will develop an evaluation framework for compliance initiatives addressing the cash economy.</p>

The Australian Taxation Office 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:

- Forums established with industry groups and business associations to facilitate information sharing and allow us to work with specific industry groups associated with focus areas throughout our cash economy projects
- Tax practitioners as a continuing key leverage point in influencing the compliance behaviours of their clients.
- A *whole of government* approach to the cash economy, working with other government agencies to promote co-operation, conduct joint activities and exchange information.
- Research to help us better understand what is driving cash economy attitudes and behaviour.
- Community engagement as a continuing key focus in our approach to increasing community confidence in the tax system. The community is engaged both through services and education, but also via regular surveys that help us track our reputation and perception in the community.