



All Party Parliamentary Taxation Group

Pre-Populated Returns

Briefing Paper – September 2009

TITLE	All-Party Parliamentary Taxation Group																																				
PURPOSE	To look at and understand tax policy and taxation at all levels; to understand VAT and PAYE in the UK; to contact and talk to accountants and Revenue officials; to look at European tax affairs and international taxation.																																				
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Information Technology and Innovation Foundation met the cost of flights and accommodation (a total of £8593) for a visit made by the Chairman to the USA and Canada from 29 April to 6 May 2008 (registered May 2008).																																					
PAID EMPLOYMENT OUTSIDE PARLIAMENT OF STAFF WHO HOLD A PARLIAMENTARY PASS																																					
None.																																					
DATE OF GROUP'S LAST REGISTERED ANNUAL GENERAL MEETING																																					
19 March 2008																																					
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Executive Summary

Approaches to income tax collection have traditionally fallen into two broad categories. In the UK the Government is at the centre of the process; the Revenue calculates the taxpayer's liability and collects it from them, through a system known as Pay As You Earn (PAYE). Other countries, notably the USA and Canada, take a more citizen centric approach where taxpayers file a yearly tax return in order to reconcile their tax liability against the tax that the Revenue has collected from them through withholding.

Both approaches have been the subject of criticism. For some a system of universal returns, where every taxpayer submits a tax return places too much responsibility upon the individual. Others have noted that Government centric approaches, like PAYE, unfairly burden small businesses and are being put under strain by increasingly dynamic labour markets driven by long term economic trends.

However, an alternative approach to tax collection, pioneered in Nordic region countries has attempted to combine the best of the citizen and government approaches. The reconciliation approach involves the Revenue sending out a pre-populated return to the individual taxpayers, containing all the information the Revenue already has, which the citizen then amends or accepts. In most cases the Revenue will also use this information to calculate the taxpayer's final liability, presenting them with a completed return.

The extent to which using pre-populated returns offers a genuine third way between the two traditional citizen and Government centric alternatives, will depend upon: its resilience against increasingly dynamic labour markets, which have put PAYE under strain; its impact upon small business administrative costs; and its ability to reduce the taxpayer's compliance burden. The practicable application of pre-populated returns will also be influenced by their impact upon taxpayer compliance.

The first use of pre-populated returns was by Denmark in 1988. Sweden introduced its arrangements in 1994, while other Nordic region countries followed in the late 1990's/early 2000's. Denmark has used the system of 'deemed acceptance' since the first year pre-populated returns were introduced and in more recent years, a number of other countries have followed suit. Where no response is received after a prescribed period, the return is deemed to have been accepted as complete and accurate by the taxpayer.

Conclusions

A reconciliation approach would not necessarily make the UK tax system any more resilient to increasingly dynamic labour markets that are putting PAYE under strain, since they both rely upon accurate withholding at source. Indeed, for this reason, it may be less attractive than those citizen centric approaches, which do not rely upon accurate withholding at source. A move away from PAYE towards using pre-populated returns would also do little to alter the imbalance between administration costs for large and small firms.

Rather than reducing the burden upon taxpayers by supporting taxpayer compliance, pre-populating returns either encourages taxpayers to absent from compliance activities or results in only a very marginal reduction in their overall compliance burden. Importantly having the Revenue calculate taxpayers' final liability for them should not play a major role in reducing the compliance burden they face.

Finally revealing to taxpayers all the Revenue's known information may encourage some taxpayers to take a risk and not disclose other income not contained in the pre-populated return. Taxpayer's perception that there is minimal risk of detection plays a significant role in determining their compliance.

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Introduction: Citizen and Government Centric Approaches

1. Approaches to income tax collection have traditionally fallen into two broad categories. In the UK the Government is at the centre of the process; the Revenue calculates the taxpayer's liability and collects it from them, through a system known as Pay As You Earn (PAYE). Employers deduct tax from their employees' pay according to PAYE codes which reflect the employees' personal circumstances. The amount withheld by employers and passed on to HM Revenue and Customs (HMRC) is designed to match exactly the tax liability for most employees. Other countries, notably the USA and Canada, take a more citizen centric approach where taxpayers file a yearly tax return in order to reconcile their tax liability against the tax that the Revenue has collected from them through withholding. Importantly the latter does not rely on accurate withholding at source, because of the end of year settlement process.
2. Both approaches have been the subject of criticism. For some a system of universal returns, where every taxpayer submits a tax return places too much responsibility upon the individual. Others have noted that Government centric approaches, like PAYE, unfairly burden small businesses and are being put under strain by increasingly dynamic labour markets driven by long term economic trends.¹
3. However, an alternative approach to tax collection, pioneered in Nordic region countries has attempted to combine the best of the citizen and government approaches. The reconciliation approach involves the Revenue sending out a pre-populated return to individual taxpayers, containing all the information the Revenue already has, which the citizen then amends or accepts. In most cases the Revenue will also use this information to calculate the taxpayer's final liability, presenting them with a completed return. In principle, the individual does not have to prepare and file their return without the State's support and the Revenue does not have to take on the administrative burden that a more Government centric approach entails.
4. The extent to which using pre-populated returns offers a genuine third way between the two traditional citizen and Government centric alternatives, will depend upon: its resilience against increasingly dynamic labour markets, which have put PAYE under strain; its impact upon small business administrative costs; and its ability to reduce the taxpayer's compliance burden. The practicable application of pre-populated returns will also be influenced by their impact upon taxpayer compliance.

¹In 1999 the Treasury Select Committee concluded that the labour market was moving towards "more flexible ways of working – precisely the ones which PAYE finds hard to accommodate". (HCTSC, 1999)

Reconciliation approach: The Nordic region countries

5. The first use of pre-populated returns was by Denmark in 1988². Sweden introduced its arrangements in 1994, while other Nordic region countries followed in the late 1990's/early 2000's. For most taxpayers in these countries the Revenue not only pre-populates the return with the information it already has on the taxpayer's wages and circumstances, but also calculates their tax liability, sending them a completed return. Denmark has also used a system of 'deemed acceptance' since the first year pre-populated returns were introduced. More recently a number of other countries have followed suit. Where no response is received after a prescribed period, the return is deemed to have been accepted as complete and accurate by the taxpayer.
6. In Estonia all income taxpayers are required fill out a tax return either by accessing an electronic version of the pre-populated return or a paper version that can be obtained on request at regional tax offices. As a small country, Estonia is able to finalise the preparation of pre-populated returns approximately within 6 weeks of the year-end, compared to periods in other countries, which vary from 7-10 weeks after the end of the fiscal year. Since 2006, from 1st February (i.e., one month after the end of its fiscal year) Danish taxpayers have had access via the internet to pre-populated return information.
7. In Sweden, taxation occurs at both a national level and a municipal level between the Ministry of Finance and the Swedish Tax Administration. The employer deducts tax before the taxpayer gets their wage. This tax is paid to the Tax Agency every month. If the employee's income varies from month to month, taxpayers can have their tax reduced (an 'adjustment'). Every April, the Tax Agency sends taxpayers a tax return form already filled in by the Tax Agency (Skatteverket). Taxpayers also receive an income specification, itemising the income and a preliminary tax estimate is sent. This is based on the information the Tax Agency has filled in on the taxpayer's tax return.
8. Based upon their survey of best practice in the Nordic region countries, the OECD (2006) identify the following factors as being critical to the successful implementation of a reconciliation approach: (a) accurate withholdings at source; (b) high integrity taxpayer identifiers, so that information from third parties can be matched easily; (c) comprehensive systems of third party reporting to the revenue body; (d) a compatible legislative framework, where the tax law provides relatively limited scope for tax deductions, rebates, credits, and discretions that cannot be predicted by the revenue body using third party reports³; (e) a high degree of automation among information suppliers; (f) large scale information processing; (g) automated and minimal interactions with taxpayers, to avoid large scale clerical (and thus costly) vetting of completed pre-populated returns returned by taxpayers to the tax body. They warn:

..all of the abovementioned factors are critical to the success of prepopulated return systems—a major weakness in any of the abovementioned areas is likely to significantly reduce the potential benefits that can be achieved in practice from the use of pre-populated returns. (OECD, 2006)

² This section draws upon the work of OECD (2006).

³ Such tax incentives are not commonly used in the UK. What tax credits are available to taxpayers have to operate outside of PAYE. If this situation was to change, and the UK was to adopt similar incentives as are prevalent in the US and Canada, this would become a major hurdle to the widespread use of pre-populated returns (and the continued application of PAYE).

9. Figure 1 below, adapted from OECD (2006), summarises the reconciliation approach, as adopted in the Nordic region countries.



Figure 1: Overview of pre-populated return systems used by Nordic region countries (Fiscal year is the same, i.e. the calendar year, in all the surveyed countries, although timelines may vary from country to country)

Analysis

10. Both Government and citizen centric approaches to tax collection have been the subject of criticism. For some system of universal returns, where every taxpayer submits a tax return places too much responsibility upon the individual. Others have noted that Government centric approaches, like PAYE, unfairly burden small businesses and are being put under strain by increasingly dynamic labour markets driven by long term economic trends. This section will examine whether proponents of the reconciliation approach are right in arguing that it offers a genuine third way between these two alternatives, as well as examining the impact of using pre-populated returns on taxpayer compliance.
11. **Impact of dynamic labour markets.** Under PAYE, the amount withheld by employers and passed on to HMRC is designed to match exactly the tax liability for each employee. For this to happen requires accurate withholding at source, in most cases from wages. However as noted by APPTG (2008), underlying changes in the labour market, which make accurate withholding at source more difficult, are putting PAYE under strain. A recent internal audit by HMRC estimated that 5.7 million taxpayers may be paying too much or too little tax (NAO, 2006). This accounts for over 15% of the taxpaying population. The numbers within employment groups that PAYE finds difficult to deal with, such as those with more than one income, are growing as is turnover in the working population.
12. As noted above, the OECD also identifies accurate withholding at source as critical for the successful implementation of a reconciliation approach:
- To minimise the incidence of large refunds of tax, and thus the desire of taxpayers to file their tax returns shortly after the end of the fiscal year, withholdings at source (where they are a feature of the tax system in place) are typically calibrated so as to ensure that aggregate withholdings over the course of a fiscal year more or less approximate to taxpayers' annual liabilities. (OECD, 2006)
- Because pre-populated returns take longer for the Revenue to issue, withholding at source has to be more accurate to ensure taxpayers are not left unable to reclaim large refunds for long periods of time.
13. The Nordic region countries have much smaller working populations than the UK's. Across the Nordic region they range from 0.638 million in Estonia to 7.1 million in Sweden where as the figure for the UK is over 29 million (OECD, 2004a/2006). In countries with smaller working populations, the impact of underlying changes in the labour market upon the Revenue's ability to accurately withhold at source may be less. A reconciliation approach would not necessarily make the UK tax system any more resilient to increasingly dynamic labour markets that are putting PAYE under strain, since they both rely upon accurate withholding at source. Indeed, for this reason, it may be less attractive than those citizen centric approaches, which do not rely upon accurate withholding at source.
14. **Impact upon small business administration costs.** The cost of administering PAYE falls disproportionately on small employers, causing a harmful distortion in the competition between small and large firms. Small firms are unable to take advantage of economies of scale open to large firms in order to reduce their PAYE administration costs (APPTG, 2008). The comprehensive systems of third party reporting needed by the Revenue in order to pre-populate taxpayers' returns, alongside the continued requirement for accurate withholding at source, would suggest that a move away from PAYE towards

using pre-populated returns would do little to alter this imbalance between large and small firms.

15. **Impact upon compliance burden for taxpayers.** Proponents of a reconciliation approach argue that it has the potential to substantially reduce the compliance burden for taxpayers, who would otherwise have to file a return themselves (OECD, 2006). However rather than reducing the burden upon taxpayers by supporting taxpayer compliance, pre-populating returns either encourages taxpayers to absent from compliance activities or results in only a very marginal reduction in their overall compliance burden.
16. It is still the taxpayer's responsibility to check that the Revenue has prepared their return correctly, even when they are sent a completed return and the Revenue has calculated their final liability for them. In principle at least, in the UK it is also the taxpayer's responsibility to check their PAYE codes to ensure the Revenue has calculated their tax liability correctly. However as noted in APPTG (2008) following sixty or so years of a Government centric approach, UK taxpayers have absented from compliance activities; they are generally unaware of the meaning of their PAYE codes and unlikely to check them. The Chartered Institute of Taxation told the Group that: "To many taxpayers HMRC are the experts...so they must be right!" (APPTG, 2008). Of course, HMRC do make mistakes and the fact that taxpayers do not check their PAYE codes is one of the reasons that errors go unnoticed and their impact is multiplied.
17. Danish Revenue authorities also deem acceptance so that if taxpayers do nothing on receipt of their pre-populated completed return, within a certain period of time the Revenue considers the taxpayer's return accepted. In practical terms therefore the completed pre-populated tax return which most Danish taxpayers receive from the Revenue is akin to the P60 form which HMRC send out to taxpayers; it is a summary of the Revenue's work on the taxpayer's behalf, rather than a resource to support the taxpayer's own compliance activities. Figure 2 below illustrates the dangers of this shift: in circumstances where the Revenue incorrectly pre-populates a taxpayer's return and the taxpayer fails to amend it, the taxpayer is then held responsible for fraud, even where their acceptance was "deemed".⁴

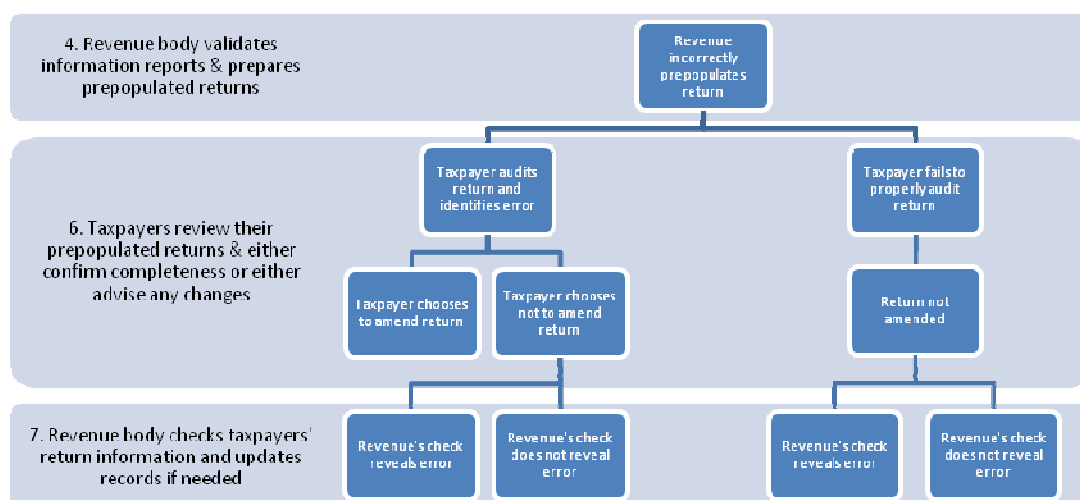


Figure 2: Decision tree for taxpayers' behaviour where the Revenue has incorrectly prepared their pre-populated return. Stages correspond to those in Figure 1, adapted from (OECD, 2006)

⁴ "Deemed acceptance of an incorrect tax return is considered positive tax fraud." (OECD, 2006)

18. There will be some taxpayers who will remain engaged in compliance activities (and who would in Figure 2 identify the Revenue's error). For them pre-populated returns will deliver only a marginal reduction in their compliance burden. Moreover having the Revenue calculate their final liability for them should not play a major role in reducing the compliance burden they face. To properly audit the return sent to them by the Revenue, taxpayers will need to go through the same process as if they were completing a return, which had not been pre-populated; otherwise they will not be in a position to make an informed decision as whether the Revenue's estimation of the tax liability is correct. Where taxpayers' compliance burden would be marginally reduced is as a result of not having to physically input information into their return, which the Revenue already has and they would otherwise have to do if their return was not pre-populated.⁵
19. **Impact upon taxpayer compliance.** Revealing to taxpayers all the Revenue's known information may encourage some taxpayers to take a risk and not disclose other income not contained in the pre-populated return (OECD, 2006), whether or not the Revenue actually completes the return. Taxpayer's perception that there is minimal risk of detection plays a significant role in determining their compliance (OECD, 2004b). If taxpayers know that the Revenue is unaware of an additional undeclared income, they are less likely to amend their return to take this into account; as opposed to where they are not aware of what the Revenue knows about their income and are preparing the return themselves.⁶

⁵ Of course, as in the case of PAYE, this cost is not eliminated; as noted above, employers, particularly small employers, and the Revenue face increased administration costs.

⁶ Countries surveyed in the Nordic region did not report this as being a problem (OECD, 2006), however other drivers of taxpayer behaviour may be compensating for this effect. For example, since perceptions of inequity also play a role, the perceived egalitarian nature of Nordic societies may encourage more virtuous taxpayer behaviour (OECD, 2004b).

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