

**PROCEDURAL JUSTICE AND THE
AUSTRALIAN TAXATION OFFICE:
A STUDY OF
SCHEME INVESTORS**

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The Australian National University
Australian Taxation Office

Centre for Tax System Integrity



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This series of working papers is designed to bring the research of the Centre for Tax System Integrity to as wide an audience as possible and to promote discussion among researchers, academics and practitioners both nationally and internationally on taxation compliance.

The working papers are selected with three criteria in mind: (1) to share knowledge, experience and preliminary findings from research projects; (2) to provide an outlet for policy focused research and discussion papers; and (3) to give ready access to previews of papers destined for publication in academic journals, edited collections, or research monographs.

Abstract

During the 1990s, Australian taxpayers who invested in mass marketed tax schemes enjoyed generous tax breaks until the Australian Taxation Office (Tax Office) told them in 1998 that they abused the system. This paper examines the circumstances surrounding the decision of taxpayers' to invest in scheme arrangements, and investors' perceptions of the way the Tax Office dealt with the schemes issue. In addition, this paper explores why such a large number of investors have chosen to defy the Tax Office's demands that they pay back taxes. Data were taken from interviews conducted with 29 scheme investors, and four non-investors, living in the Goldfields region of Western Australia. Consistent with the procedural justice literature, the findings revealed that many scheme investors chose to defy the Tax Office's request that they pay back tax because they perceived the procedures that the Tax Office used to handle the situation as unfair. The implications of these findings are discussed and possible solutions for how the Tax Office might prevent a re-occurrence of the situation in the future are proposed.

Procedural Justice and the Australian Taxation Office: A study of tax scheme investors

Kristina Murphy

Introduction

In June 1998 the Commissioner of Taxation announced that the Australian Taxation Office (Tax Office) would be implementing a series of initiatives aimed at combating aggressive tax planning. Part of their crackdown on aggressive tax planning involved issuing amended assessments to tens of thousands of taxpayers involved in mass marketed tax effective schemes. The Tax Office maintains that taxpayers who became involved in aggressive tax planning by investing in these schemes did so for the ‘dominant purpose’ of obtaining a tax benefit, and as a result the anti-avoidance provisions of Part IVA of the Tax Act apply. Scheme investors were therefore asked to pay back taxes, interest and appropriate penalties. It has been suggested by the Senate Economics Reference Committee (see Senate Economic Reference Committee, 2001) that the average tax debt incurred by scheme investors is well over \$75 000, indicating the high level of burden placed on each investor.

Before examining why such a large number of scheme investors have so far refused to pay back their taxes, this paper will begin by discussing the history of the rise of tax effective schemes in Australia and the Tax Office’s response to it. The aim of the present study is then outlined, followed by a review of the procedural justice literature that potentially offers insights into why such a large number of scheme investors initially refused to pay back their taxes. The methods used in the present study and the research findings are then presented, followed by a discussion of their implications. The paper concludes with suggestions for how the Tax Office may be able to improve its relationship with non-compliant taxpayers, as well as how the Tax Office can prevent a re-occurrence of the schemes issue, in the future.

Background

The rise of the tax scheme market

The Tax Office's concern in the area of aggressive tax planning arose out of its analysis of internal and external information that showed a dramatic increase in the number of taxpayers involved in scheme arrangements.¹ This coincided with an increase in the amounts being claimed as tax deductions. As can be seen in Figure 1, this surge in growth coincided with the 1995-96 income year, with deductions growing from \$54 million in the 1993-94 income year to over \$1 billion in the 1997-98 income year.

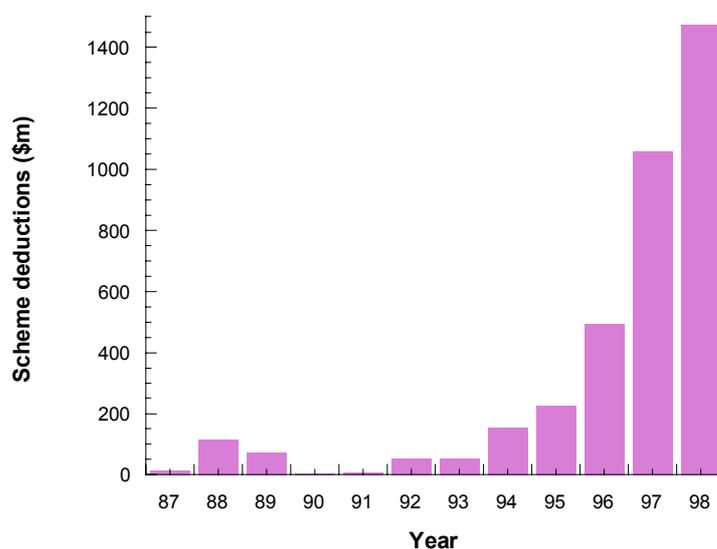


Figure 1. Growth in claimed scheme-related deductions from 1987 to 1998 (Source: personal correspondence with the Tax Office).

The Tax Office's concern over mass marketed schemes was further heightened when they analysed some of these scheme arrangements and gained a better understanding of the way they were structured. In the Tax Office's view, the fundamental compliance problem or 'tax mischief' common to these schemes related to their financing, and not necessarily their commercial nature or business activity (for an example of a franchise scheme see Appendix A). According to the Tax Office, many participants' investments were largely or

almost wholly funded through tax deductions and relatively little private capital is said to have been at risk. This view was reiterated by the Commissioner of Taxation, when he stated:

The underlying activity is not itself the issue of concern here. What is of concern to us in a range of cases are the financial arrangements associated with the investments. These often have the effect that the financing of the activity is significantly funded by taxpayers generally from the tax system. (Source: Carmody, 1998)

More specifically, the following characteristics of mass marketed schemes led the Tax Office to form the opinion that schemes posed a serious compliance problem (for a detailed discussion see ATO Submission No. 845 to the Senate Economics Reference Committee, 2000):

- Apart from subscribing to the scheme, participants have no hands-on involvement and therefore are not carrying on a business;
- Financial arrangements involve limited- or non-recourse loans, often based on round robin arrangements (see Appendix B for definitions);
- High up-front management fees geared to create inflated tax deductions;
- Participants have little or no practical control over the scheme's management;
- Limited exposure to risk; and in some cases
- A guarantee from promoters to reverse the transaction if claimed tax deductions are not allowed.

In order to address the increasing compliance problem posed by schemes, the Tax Office therefore decided to take action against the 42 000 participants thought to already be involved in such schemes.² By taking action against the investors, the Tax Office saw it as a way of discouraging future marketing and investment in such arrangements.

¹ A tax scheme is defined as an arrangement, whether legally enforceable or not, that is entered into by a taxpayer in order to obtain a tax benefit (Deutsch, Fullerton, Gibson, Hanley, Plummer & Snape, 2001).

Chronology of the Tax Office's response to the rise of mass marketed schemes

The Tax Office has been strongly criticised by a number of groups (that is, investors, accountants, Commonwealth Ombudsman, Senate) for its apparent lack of timeliness in taking action against scheme arrangements and their investors. This section attempts to provide an overview of the Tax Office's response to the rise of the mass-marketed schemes market in Australia and the strategies it initially put in place to combat scheme involvement.

Between 1987 and 1994, the Tax Office investigated at least 14 schemes and a further 14 from 1995 to 1997. The Tax Office applied Part IVA and disallowed deductions in nine of the first 14 schemes investigated. The primary reason for disallowing those deductions was their use of limited or non-recourse financing. Here, the borrower is not personally at risk to repay the loan, apart from the specified security, which is tied to the scheme's earnings (see Appendix B).

Although investigations had begun in 1987, it was not until early 1997 that the Tax Office recognised that a potential compliance issue existed. Such an issue became obvious by the growing numbers of tax instalment variations being lodged. The Tax Office also asserts that the market changed dramatically not only in scale, but also in the nature of the schemes being promoted. This change appeared to alarm the Tax Office due to the potential for exponential growth in such arrangements. In evidence provided to the Senate Economics Reference Committee, an officer from the Tax Office reported the following:

What we saw in 1995-96 was a move away from tangible activities [primary produce] to more intangible activities. We saw that the Budplan scheme, which emerged out of a tea-tree plantation to be a supposed business carrying out research into the use of tea-tree oil. At about the same time that emerged, the franchise schemes that were prevalent in Western Australia also emerged. Those particular schemes were also not constrained by the need to have some form of agricultural property behind them. That combination of factors resulted in a surge in these

² A total of 56 329 investments were made, indicating that many investors had multiple investments.

activities in 1996 and 1997 (Source: Senate Economic Reference Committee, 2001, p 17).

Once the compliance problem was identified in 1997, a consultative document and a draft ruling on afforestation schemes were issued which considered characteristics of unacceptable schemes. Tax Office position papers on over ten schemes were also issued. In addition, the processing of certain scheme-related tax instalment deduction variations were stopped. Yet, it was not until 1998 that the Tax Office moved decisively on a large scale to disallow deductions related to mass marketed arrangements. This included issuing over 10 000 letters to participants in over ten schemes to inform investors that their deductions had been disallowed. In 1998, initiatives aimed at recovering deductions from scheme participants were also introduced and four quite pointed speeches were given and received extensive media coverage. 1998 also saw the introduction of the Product Ruling system that aimed to provide certainty for potential investors by confirming the tax benefits of an investment (see Appendix B).

Since introducing the Product Ruling system in 1998, the Tax Office has introduced three further significant measures. One is a set of guidelines that advise investors of settlement options. The second is a key taxation ruling (TR2000/08) that sets out the Tax Office's view on investment schemes. The third measure has been to introduce a Taxpayer Alert system in 2001 that warns taxpayers about significant new tax planning issues and arrangements that are of concern to the Tax Office.

Aim of the present study

While the Tax Office has implemented measures aimed at combating future taxpayer involvement in aggressive tax planning schemes, the issue of the Tax Office's initial handling of the mass marketed schemes problem still remains. Only a minority of scheme participants agreed to pay back their tax debts (which included interest and penalty components) as soon as they received their amended assessments. The question of why such a large number of participants chose to defy the Tax Office's demands that they pay back their taxes, is of theoretical interest both to psychologists and policy makers, and will

be the focus of the present study.³ It should be noted at this point that it is not the aim of the present paper to discuss the legal issues surrounding the mass marketed schemes issue. Instead, the present paper aims to present the views expressed by the investors interviewed and will attempt to provide a possible explanation to why they reacted in such a negative way toward the Tax Office's handling of the issue.

Procedural justice

So what is it that makes people obey or disobey an authority's decisions? Why people choose to obey or disobey decisions made by institutions has been the topic of much psychological research since the late 1950's (for example, Easton, 1958; French & Raven, 1959; Tyler, 1990; 1997; Tyler & Lind, 1992). Possible reasons why scheme participants may have reacted as they did can be found in this literature.

According to Tyler and Smith (1998), people's *behaviour* is strongly linked to views about justice and injustice, with perceptions of justice strongly related to feelings of anger (Montada & Schneider, 1989), self-worth, and self-concept (Tyler & Smith, 1998). Procedural justice concerns the perceived fairness of the procedures involved in decision-making and the perceived treatment one receives from the decision maker. Procedural justice judgments have been demonstrated to have an important influence on people's evaluations of group authorities, institutions, and rules (Tyler & Lind, 1992). In fact, there is evidence to show that people who feel they have been treated fairly by an organisation are more inclined to accept its decisions and follow its directions (Lind & Tyler, 1988). It has also been found that people are most likely to challenge a situation collectively when they believe that the procedures are unfair and that they personally suffered because of the injustice (Tyler & Smith, 1998).

³ At the time of conducting the fieldwork for this study in October 2001 (three and a half years after the Tax Office first took recovery action against investors), less than 50% of scheme investors had entered into settlement arrangements with the Tax Office to pay back their tax debts. In February 2002, however, the Tax Office announced a settlement offer to investors whereby the interest and penalties on their scheme related debts would be abolished. Investors were given until June 21st 2002 to decide if they would accept the offer. The offer has been highly successful for the Tax Office. As of June 21st 2002, 87% of investors have been reported to have taken up the new offer (Source: Tax Office correspondence).

The 'group value approach' in the procedural justice literature highlights the importance of relational issues such as an authority's trustworthiness, interpersonal respect, and neutrality in its dealings with others (Tyler, 1989; 1994; 1997; Tyler & Smith, 1998). One's judgment about whether or not an authority is motivated to treat them in a fair way, to be concerned about their needs, and to consider their arguments (that is, their trustworthiness) has been shown to be the primary factor that people consider when evaluating authorities (Tyler & DeGoey, 1996; Tyler & Lind, 1992). If people believe that an authority is 'trying' to be fair and to deal fairly with them, they trust the motives of that authority and develop a long-term commitment to accepting its decisions.

Research has also shown that being treated politely, with dignity and respect, and having genuine respect shown for one's rights and social status, all enhance feelings of fairness. These findings are especially striking in that such treatment is essentially unrelated to the manner in which their dispute is resolved (Tyler, 1997). People are also influenced by judgments of the neutrality of decision-making procedures. Neutrality includes assessments of honesty, impartiality, and the use of fact, not personal opinions, in decision-making. People basically seek a level playing field in which no one is unfairly advantaged. As people are seldom in the position to know the correct outcome, they focus on the evidence that the procedures are even-handed.

In addition, the provision of information about procedures and explanations for decisions is also seen as particularly important for people's perceptions of fairness and decision acceptance (Greenberg, 1993a; 1993b).

Legitimacy

Within political psychology, procedural justice is widely hypothesized to be an antecedent of legitimacy. The feeling of obligation to defer and accept is typically labeled legitimacy—the belief that authorities are entitled to be obeyed (French & Raven, 1959). Researchers (for example, Tyler, 1997; Tyler & Lind, 1992) have argued that people who feel they have been fairly treated by an authority regard their authority status as more legitimate. If an organization is perceived to be legitimate then people are generally more

likely to follow and accept their decisions, regardless of the favourability of the decision outcome.

Critics of the procedural justice view have suggested that people would care more about the outcome favourability (for example, how much money they stand to lose) and less about fairness when the stakes are high. However, research has not supported that argument. Instead, it has been shown that concerns about fairness remain high when outcomes are important (Casper, Tyler & Fisher, 1988; Lind, Kulik, Ambrose & de Vera Park, 1993). For example, in a study of authorities in political, legal, managerial, educational, and family settings, Tyler (1997) found that authorities draw an important part of their legitimacy from their social relationship with group members. Specifically, Tyler showed that treatment by authorities affected views about their overall legitimacy, not judgments about gain or loss. Tyler concluded that people value respectful treatment by authorities and view those authorities that treat them with respect as more entitled to be obeyed.

Justice in the taxation context

While the literature indicates that government institutions can benefit by employing fair procedures, little empirical research has been conducted on the effects of procedural fairness on tax compliance. Of the research that has been conducted, however, it has been shown that taxpayers are generally more compliant when they think they have been treated fairly and respectfully by a tax authority. For example, Alm, Jackson and McKee (1993) investigated whether procedural aspects of a decision about how tax revenue should be spent affected tax compliance. As predicted, it was found that taxpayers were more likely to respond positively—and so to increase their tax compliance—when faced with a tax expenditure program that they selected themselves. When the decision was imposed upon them, compliance suffered. In a study of Australian taxpayers, Wenzel (2002) also studied the impact of justice perceptions, but this time on self-reported tax compliance. Using a survey methodology, Wenzel found that taxpayers were more compliant when they thought that they had been treated fairly and respectfully by the Tax Office.

Perhaps of most relevance to the present study was the research conducted by Stalans and Lind (1997). Their study compared how taxpayers and their tax preparers judged the procedural fairness of tax audits and the Internal Revenue Service (IRS). Seventy taxpayers participated in interviews after the completion of their tax audits and were asked to describe their impressions of the audit and the auditor, and to rate how satisfied they were with the auditors' treatment and fairness. Both taxpayers and representatives who viewed audits as a procedure that should indicate the truth about the accuracy of their return, were less satisfied with how the auditor treated them. In addition, they were less likely to think that the auditor tried to be fair when compared to representatives who viewed the audit process as a way of achieving the best outcome for their clients. After completion of the audit, taxpayers were also asked about their views toward the IRS. In general, it was found that taxpayers thought the IRS treated honest taxpayers like they had done something wrong.

In sum, the procedural justice literature argues that individuals do not react to authorities primarily or exclusively in terms of what they do or do not receive from those authorities. Instead, they react to how they are treated. If individuals trust the motives of authorities, feel that they behave neutrally, and feel treated with respect and dignity, they are more willing to voluntarily defer to authorities and obey their decisions.

In relation to the present study, many scheme investors openly questioned and rejected the Tax Office's decision that investors should pay back tax with interest and penalties. The reason why so many investors have done this was therefore the question of interest.

Method

In order to examine scheme investors' perceptions of the Tax Office's handling of the schemes issue, scheme investors were engaged in in-depth interviews. Over a two-week period in October 2001, exploratory interviews with scheme participants were conducted in the goldfields region of Western Australia.⁴ The semi-structured interviews averaged

⁴ Interviews were conducted in the goldfields area of Western Australia because of the large number of residents known to be involved in tax effective schemes. This region is recognised for its prominence in the

approximately one hour and explored the circumstances that led participants to invest in scheme arrangements, respondents' experiences with the Tax Office, and their beliefs about the Tax Office and its procedures. All interviews were tape-recorded for subsequent transcription and analysis.⁵

In order to find an adequate number of scheme investors to interview, a 'snowball' technique was used. Initially, key community groups in Kalgoorlie were contacted and briefed about the aim of the project. The names of investors who were particularly vocal in the community were then provided. These investors then suggested the names of additional investors who they thought might be interested in participating in the study. Approximately 90% of those contacted by phone agreed to participate. Several additional investors also volunteered to participate in the study. A total of 19 interviews were conducted with 29 investors⁶.

In addition to the interviews with scheme participants, an accountant, a coordinator from a community legal centre, a mine manager, and a community worker were also interviewed. Thus, a total of 33 people were interviewed.

Findings

The data consisted of scheme investors' responses to a variety of questions designed to measure how they came to be involved in scheme arrangements, their views toward Tax Office procedures, and their thoughts of the time delay between the growth of the schemes market and the Tax Office's decision to disallow deductions. An overview of the responses given to these questions is presented in the following sections.

mining industry, with approximately 22% of the total workforce employed in this area (Department of Local Government and Regional Development, 2001). Given that the incomes earned by most miners place them into the highest tax bracket, it is little wonder why the region was a target for promoters selling tax avoidance schemes.

⁵ At the request of one investor, his interview was not tape-recorded.

⁶ It is acknowledged that the sample size here is small and may not be representative of the entire population of scheme investors. The intention of the present paper was to provide an exploratory analysis of the perceptions held by taxpayers involved in mass-marketed tax effective schemes. Work is currently being undertaken on a national sample of 6 000 investors to see if the conclusions made in this paper can be extended to a larger national sample.

While it is acknowledged that only 29 investors living in the goldfields region were interviewed, the situation surrounding their outstanding debt was quite varied. Two investors had already fully paid back their outstanding tax debt, two investors had or were attempting to enter into payment settlements with the Tax Office, five had either filed for bankruptcy or were seriously considering the option, eleven had joined fighting funds in an attempt to absolve them of any debt, six were waiting to see the outcome of various court cases before deciding what to do, two stated that they refused to pay the bill, and there was one who simply chose to ignore the situation.

How did investors hear about the schemes?

Participants were first asked to explain how they came to hear about the schemes they invested in. One investor explained how they had seen a pamphlet in their letterbox. To hear more about the investment, they then contacted the ‘financial adviser’ whose name was printed on the pamphlet. Eleven other investors initially got the idea from a friend or family member, eight from their accountant or financial advisor, and nine from a door-to-door salesman promoting the product (in some cases this salesman was a financial planner).

Of particular interest was the finding that 25 of the 29 investors interviewed said they sought additional independent advice from a third party as to the legitimacy of the scheme arrangements they were about to invest in. For example, 25 investors said they sought advice from their accountants and solicitors. A small minority of these 25 investors said they also sought additional advice from the Australian Securities and Investment Commission and the Tax Office⁷. One investor made the following point about the advice he received from his accountant:

When you’ve got a CPA who knows the tax law saying, ‘This is a sound investment, there’s no problem with it’, then why wouldn’t you do it?

In fact, one investor explained the reason why he had used a tax agent:

⁷ From the interviews, however, it is not clear what advice they were given from the Tax Office, as the Tax Office does not give financial advice over the phone.

I thought that if an accountant did your tax you were less likely to be audited because the tax accountant themselves went through a reasonable amount of due process to make sure it was all ridgy didge and above board.

Many investors expressed similar views when discussing their tax agents. This seems to suggest that many investors thought they took the correct steps to check the legitimacy of the schemes in which they invested. In fact, many investors believed that they had done all that was possible and expected of them under the self-assessment system. They were therefore surprised when the Tax Office later disallowed their deductions and penalized them for ‘avoiding’ their taxes.

Reasons for investing

The draw card of many investments is that they proffer the opportunity to legally minimise tax. In fact, Braithwaite, Reinhart, Mearns and Graham (2001) found that approximately 22% of Australian taxpayers look at several different ways of minimising their tax each year. While many of the scheme participants interviewed acknowledged that they entered into scheme arrangements because the touted tax breaks were attractive, they were adamant that they did not enter the schemes for the dominant purpose of avoiding tax. Investors asserted that the schemes they had invested in had been sold to them, sometimes by their accountants, as a way that they could legally minimise the tax they were required to pay while still being involved in a viable long-term investment⁸. One investor mentioned the conversation he had with his accountant before investing in tax schemes:

I suppose I had been going to my tax agent, and I've been concerned that I've been paying that much tax. I don't mind paying tax, you know, but I've been concerned that I've been probably paying more than I should have so I've been asking him questions about it and he said there's a couple of investments you can go and invest in. And he put a couple forward to me and I said, I'm not interested in those. I

⁸ Some people still question investors' underlying motivations, however, based on the argument that the investments they entered into seemed ‘too good to be true’. In retrospect, this might be the case. But as can be seen in this study, the majority of investors interviewed sought advice from their accountants as to the

specifically said, 'I don't want to go into anything that's illegal. It's got to be ridgy-didge'.

Later, the same interviewee said, when asked about whether he had questioned his accountant about the tax benefits offered by the schemes he got involved in:

I asked about the tax on it and I said 'What's the deal with the tax here? Is that still legitimate?' And I was told yes. So I just took that attitude and okay, it's no big deal. My tax accountant thinks it's okay, why wouldn't I?

This comment highlights the trust taxpayers place in their tax agents. It also emphasizes the importance that tax agents play in taxpayer compliance, and in this case, non-compliance. Sakurai and Braithwaite (2001) discuss how taxpayers open to low-risk tax minimisation strategies often find themselves with tax agents who serve taxpayers open to high-risk minimisation strategies. Tax agents are usually expected to correctly interpret the level of risk their clients are willing to take and are also expected to judge what is acceptable minimisation behaviour. Often, however, this does not occur, as can be seen from the comments made by the investor above. Tax agents tend to be more adventurous than their clients in thinking a particular minimisation strategy will be upheld by a subsequent legal challenge (Hansen, Crosser & Laufer, 1992). Thus, what is high risk for a taxpayer may be considered low risk for an agent. But under the self-assessment system of taxation, it is the taxpayer who then faces the consequences if the strategy used is called into question by the Tax Office.

Whilst aware of the taxation benefits arising from the initial investment, many investors believed that these benefits were acceptable to the Tax Office because they were more than outweighed by the potential tax on future returns.⁹ As one investor said about his investment, 'We were making money on it and we're paying the tax on it'. A small number of investors said that they saw investing in their schemes as a way to support Australian

legitimacy of the investments. They were therefore led to believe that the investments were legitimate and above board.

⁹ Of course investors were not to know that because of the way many investments had been set up that there would be no returns.

business. As can be seen from the following quote, one investor actually said that investing in a forestry scheme was a good way to redirect her taxes into rural areas:

We were also told that our tax money was getting channelled into the country areas; it was a way of directing our tax into the country areas where people would be employed. And coming from a country area, I thought that was right-on. For me it was doing something with our taxes other than paying people who don't want to work.

In addition, many investors commented on how they were trying to set themselves up for retirement. As one investor noted:

I figured there will be no such thing as a pension by the time I retire. So, I mean, how do you live? You've got to have something.

With the pension slowly being phased out, and the government encouraging Australians to 'look after themselves' in retirement, one could argue that there is little wonder why so many people were being lured by investments which required no initial cash outlay.

While it is acknowledged that some scheme participants may have invested in schemes to avoid tax, it should be noted that all of the investors interviewed in the present study said they were led to invest based on trust in the proposals marketed to them. In some cases, the proposals were marketed by respected accountants and financial advisers. Thus, it is proposed that the subsequent reaction by such a large number of investors to defy the Tax Office's decision that they pay back taxes, could have been due to the Tax Office's initial handling of the schemes issue. Specifically, many investors felt that the Tax Office treated all scheme investors as 'tax cheats'. This idea is pursued in more depth in the following section.

Procedural justice and the Tax Office

Government agencies such as the Tax Office often find themselves attempting to elicit certain behaviours (for example, pay your fair share of tax) in order to obtain what they see as a solution to a given social problem (for example, funding services). These attempts to elicit or change a particular behaviour sometimes involve persuasion and sometimes involve more or less coercive tactics. While some research supports the view that deterrence measures can affect tax behaviour (for example, Allingham & Sandmo, 1972), other more recent research suggests that the effects of threat and coercion can sometimes be counterproductive (for example, Ayres & Braithwaite, 1992; Blumenthal, Christian & Slemrod, 1998; Braithwaite & Braithwaite, 2001; Taylor & Wenzel, 2001; Wenzel, 2001). In fact, research into reactance has shown that the use of threat and coercion, particularly when perceived as illegitimate, can produce the opposite behaviour from that advocated. In other words, these actions are more likely to result in non-compliance or overt opposition (Brehm & Brehm, 1981).

Tax Office letters

As discussed by Wenzel (2001), letters are probably the most frequently and broadly applied measure that the Tax Office uses to communicate and gain compliance from non-compliant taxpayers. These letters, however, have often been regarded as too technical (Australian National Audit Office, 2001).¹⁰ The letters that were sent to scheme investors were also regarded by those interviewed to be too technical, unsympathetic and threatening. The following comment, provided by one investor, supports this claim:

And the letters you get from the ATO. You know, like, as I said, an average educated person won't be able to construe the terms they're using there. I mean, they're just over my head ... They just baffle you.

¹⁰ In a performance audit of the Tax Office, the Australian Auditor-General also found that Tax Office letters to taxpayers are 25 percent more difficult to read than what is recommended. It was therefore suggested in the report that the Tax Office work to improve their communication with taxpayers by improving the reading ease of letters and documents sent to clients (see Australian National Audit Office report No. 37, 2001).

Many investors interviewed also expressed anger at the lack of consultation and warning they received before being issued with letters telling them that their deductions had been disallowed.¹¹

The Tax Office's procedure of sending a large number of amended assessments several days before Christmas was also seen to be particularly callous and unsympathetic:

MALE: When I got the first letter from the ATO.

FEMALE: Christmas 2000, wasn't it?

MALE: It would be something like that, wouldn't it? I said, 'Oh, this is a fantastic Christmas present', you know? Really livened my Christmas up for me.

On talking about the timing of the letters, the following investor said:

The timing of the letter wasn't anything but the fact of the way it was written, 'Righto, you've got 14 days to pay ... or this will take place. We'll start recovery action'. And you go, 'Hang on, what's all this mean'.

The technical language and demands used in the letters left investors feeling overwhelmed, confused and angry. The failure of the Tax Office to advise investors of the settlement provisions, debt recovery policies and hardship relief measures offered by the Tax Office was also met with disappointment.¹² As one investor commented:

I'm really disappointed with them ... they don't offer to help, maybe if they'd offered a payment plan or something to ease the burden of this big bill you know like and not put all this - keep putting this interest on, it's just ridiculous. If they'd have come up and said you know like you've got this bill, you've made a mistake, we've made a mistake but this money has to be paid back, but you can do it this way. I mean that would have been heaps easier than you're a tax cheat, you've got to pay \$40 000 now or we're going to put all this interest on it, you'd just never get it paid.

¹¹ In this regard, investors were unaware of the extensive consultation that the Tax Office had undertaken with the promoters and advisers who represented investors.

It appears that this investor felt that the Tax Office had not been helpful in looking for a cooperative and fair solution. Even when investors actively sought help by calling the Tax Office contact number given in their letters, they said it was not forthcoming. As one investor said:

You can ring the ATO five times in a week and ask the same question and get five different answers.

Another investor said in her interview:

They just don't try to help you at all and every time you ring them, I learnt the hard way, you have to get the person's name that you talked to or you ring the next day and nobody knows what you're talking about.

When questioned about whether they had spoken to their Tax Office assigned case officer¹³, one investor said the following:

I've got a case officer I spoke to once on the phone. I might as well ring up Don Burke because they don't tell me anything. They tell me what I already know.¹⁴

Of the minority of investors who had any knowledge of their caseworkers, they indicated that their caseworkers were not particularly helpful.

To make matters worse, many scheme investors felt that the Tax Office letters sent to them implied that they were 'tax cheats' by stating that their dominant purpose for entering into a scheme arrangement was to avoid tax (that is, Part IVA of the Tax Act applied).¹⁵ Although the Tax Office did not actually use the words 'tax cheat', many investors believed that it was implied. This perception was met with intense anger and dissatisfaction

¹² It should be noted that the Tax Office has now gone to great lengths to improve the quality and information contained within its letters to investors. Information contained in the letters outlines possible payment plans and provides the name of a case manager in which the investor can speak to.

¹³ Assigning a particular case officer to each investor was a Tax Office initiative introduced in April 2001.

¹⁴ Don Burke is the host of gardening program in Australia.

¹⁵ The label 'tax cheat' was a term introduced by the media to describe tax scheme investors. The term has since been used by investors when discussing how they think the Tax Office views their tax behaviour.

with the Tax Office, as can be seen from the comments provided by several investors below:

As far as I am concerned, I've been really really badly treated by the ATO. They've just seen me as a tax evader. No worrying about my circumstances or my reasons for going into it or anything. They've just nailed me.

It's pretty damn rude to give me a tax return and then say, 'Bad luck, by the way you're doing something illegal. Actually you're a tax cheat.'

It [the letter] had all these things about schemes and you're fraudulent and whatever and I just saw red.

Why investors reacted so strongly to the 'apparent' accusations in the letters might relate to their perceptions of justice. As mentioned earlier, perceptions of justice are strongly related to feelings of self-worth and self-concept. Tyler and Smith (1998, p. 596) noted that individuals use the justice of their social experiences to define and evaluate the status of their group and within that group their social standing, their self-worth and their self-concept. Research conducted at the Centre for Tax System Integrity has shown that most Australian taxpayers express pride in being a member of the group called 'honest taxpayers' (see Braithwaite et al., 2001). In the case of scheme investors, the label 'tax cheat' appears to have threatened their inclusion in this group. As one investor said:

I've been in the mining game for probably nearly nine or ten years now so in that period of time I've paid a lot of tax and never, ever have I ever had an audit done on me, never had any queries, no dramas at all, just the average, law abiding person that pays their tax.

Thus, the reaction of so many investors to defy the Tax Office's request that they pay back taxes appears, in part, to be one of protest at being branded a tax cheat. The following quote from an investor who had initially tried to pay off their debt sums up the attitude and mindset held by so many investors in the goldfields region:

In hindsight, I'm glad he [the bank manager] didn't [give me a loan] because at the end of the day I'd much sooner fight, because I still don't think that I did anything wrong.

A question of timeliness

As mentioned earlier in this paper, one of the major criticisms of the Tax Office's handling of the mass marketed schemes issue was their delay in making the decision to crackdown on tax avoidance schemes. Although investigations into schemes had started in 1987, it was not until 1998 that the Tax Office actively sought to recover lost revenue from scheme investors. This time delay had two important consequences. First, for many investors, the refund of their initial deductions encouraged them to invest in subsequent schemes, thus serving to increase their overall tax debt. As one investor said:

That's just so unfair, they were just negligent, just slack. I mean, there's obviously a better word, but yes, not warning people, because people once they're told they're okay and they've got their deductions, but obviously now they're telling us that we can go back, but the average person doesn't realise.

Many investors had also sat by for a number of years watching friends and relatives invest in schemes. As one investor said, her sister had been involved in schemes since 1995:

They had been doing it for years, so we thought, by now if it was bad, the government would have stopped it.

In 1998 she and her husband invested in a scheme called Banalasta Oils, and as a result now owe the Tax Office thousands of dollars.

The second consequence of the Tax Office's time delay was that it had the effect of magnifying the interest charge levied on participants' tax debts because the Tax Office applied interest from the date the deduction was initially made. This was seen by investors to be particularly unfair. One investor expressed confusion toward the amount she owed the Tax Office.

We were expecting something like \$10 000 because I mean really that was all the extra sort of cash that did come out of our tax return and when you open this bill for \$40 000 I nearly fainted, yeah. I mean how come we had to pay all of a sudden \$40 000 from \$10 000? That part I couldn't understand.

It became apparent that a large proportion of the \$40 000 debt had come from penalties and the accrual of interest from the time the deduction had first been claimed. Many investors were similarly confused about how the Tax Office had calculated their tax debts. In particular, investors were confused and angry about having to pay such large amounts of interest because of the Tax Office's perceived lack of timeliness to identify the problem in the first place.¹⁶ As can be seen in the following quote some investors indicated that the abolition of penalties and interest (as recommended by the Senate Economics Reference Committee) would be a significant step toward bringing the matter to a close:¹⁷

So, I would like to see them squash the interest rates, and squash the penalties because we didn't do anything wrong. We bought into something that we thought was going to be a good thing, not for the sole purpose of evading tax or cheating the ATO or whatever they want to put it these days.

Summary

Upon interviewing scheme investors it became apparent that the investors interviewed perceived the Tax Office's handling of the schemes issue to be procedurally unfair¹⁸. As can be seen from the majority of quotes presented in this paper, these scheme investors did not feel fairly treated by the Tax Office. This finding is interesting because it indicates that investors were not *purely* driven by self-interest variables as one might have expected, but that they were also strongly concerned about issues of fair treatment and respect in forming

¹⁶ However, it should be noted that the anti-avoidance provisions of the Tax Act allow the Tax Office up to six years to disallow a claim. The Tax Office therefore argue that action was taken within the time frame provided by the law.

¹⁷ In fact, many investors indicated that they would be happy if the recommendations set out in the Senate Economics Reference Committee's Interim report (2001) were accepted by the Tax Office.

¹⁸ This was the case even for investors who had already paid any outstanding debts or who had entered into settlement arrangements with the Tax Office.

their opinions about the Tax Office's handling of the schemes issue. Specifically, the major areas of concern to the investors interviewed were the Tax Office's failure to identify earlier the compliance risks posed by schemes, their failure to consider individual investors' motivations for entering into scheme arrangements, their general lack of helpfulness, and their lack of empathy for the financial hardship faced by many investors. In addition, scheme investors felt stigmatised by being thought of as a 'tax cheat'.¹⁹

Implications

The purpose of the research presented in this study has been to emphasize the centrality of legitimacy in an authority's ability to shape the voluntary compliance of its members. As noted in the introduction, if an organisation is perceived to be legitimate then individuals are generally more likely to follow and accept their decisions, regardless of the decision outcome. Part of forming an opinion of an authority's legitimacy involves the way individuals feel treated by that authority. In particular, individuals who feel they have been treated fairly by an authority are more inclined to accept its decisions and follow its directions (Lind & Tyler, 1988). When questioned about how he now viewed the Tax Office, one investor said:

Well, I don't trust them any more. I always thought, you know, if you filled the form out properly and you did the right things and went through your normal accountant, registered accountant, or whatever, they would just get on with the business. But what it has actually alluded to me is that they're not very well organised; they are running a reactionary-mode tax department.

With scheme investors questioning the legitimacy of the Tax Office, the potential for further uncooperative behaviour is a real possibility. For example, we have seen a rise in the number of fighting funds being set up to represent investors' interests. These fighting

¹⁹ While the findings of this study suggest that it was the Tax Office's 'unfair' treatment of scheme investors that led to investors' widespread defiance, it should be noted that the conclusions made in this paper are based on a small sample (N = 29 investors). Further work will need to be done on a national sample of investors to confirm whether the feelings expressed by the investors in the present study are shared by others living in different regions of Australia. Work currently being conducted at the Centre for Tax System Integrity aims to explore this question by surveying a random sample of scheme investors from all over the country.

funds offer 'resistant' investors the chance to have their say and the opportunity to fight the Tax Office's view of the law in court. In fact, the fighting funds have made the public more aware of their rights, that they are able to express their rights and that they can defend them when necessary. In other words, they have made the public aware that they can challenge the authority of the Tax Office.

It is not surprising that the various fighting funds and lobbying groups have been formed under the circumstances. Research has consistently shown that individuals seek justice in a number of ways when they feel that the groups to which they belong have been treated unfairly (see Tyler & Smith, 1998). These ways can include pursuing collective change in ways that are socially acceptable (for example, political lobbying), or turning to third parties to intervene (for example, taking a class action, referring the decisions to the courts), as is the case with the fighting funds.

The major concern about these fighting funds, however, is that in some cases the legal firms whose partners were involved in promoting tax schemes and recommending them to their clients in the first place are now running cases against the Tax Office. So whether these groups are truly acting in the interests of their clients or whether they are simply fuelling taxpayer non-compliance to advance their own agenda is unknown. When questioned about whether they knew of the potential conflict of interest, one investor said:

Yeah, but who else am I going to use? What else am I going to do? Without going and paying into the fighting funds, you've got no hope, absolutely none. That is the only course open to anybody, is legal representation. And who on their own can afford to take on the ATO?

While investors' involvement in fighting funds poses a problem for the Tax Office, the real problem comes from investors who are now choosing to disengage from the tax system. A small number of investors interviewed did not express any interest in becoming involved with the various fighting funds. Instead, they showed signs of more extreme defiance toward the tax system by expressing views that paying tax should now be avoided as much as possible. As one investor said:

Every carpenter or plumber or electrician or any of those that I use now, I always say to them, 'How much for cash'. Because I thought, well, stuff it. I'm going to stop the Tax Department from getting as much as they can. So I'll just pay all the tradesmen cash. They love it. Beautiful. They don't have to declare it. And that mindset will grow. You know, it's just my little way of thinking, I'm having a win. No worries. I'll just make you lose a little bit more.

The real threat to the integrity of the tax system comes when disengaged taxpayers such as these seek out alternative ways in which they can further exploit the tax system. Such ways may include seeking out others who can help them to achieve their purpose. For example, those with tax law expertise.

Self-assessment has given rise to a professional culture that prides itself on knowing tax law, how to take advantage of it, and most importantly, on meeting customer demand (Braithwaite, forthcoming; Erard, 1993; Klepper & Nagin, 1989; Klepper, Mazur & Nagin, 1991; Murphy & Sakurai, 2001; Sakurai & Braithwaite, 2001). With disgruntled taxpayers questioning the legitimacy of the tax system, the opportunity arises for these professionals to position themselves as an alternative authority to the Tax Office; an alternative authority that fosters non-compliance (see Braithwaite, forthcoming; Murphy & Sakurai, 2001).

Research conducted at the Centre for Tax System Integrity has shown that these professional groups have in fact captured the psyche of many disgruntled taxpayers. In a study of Australian taxpayers, Sakurai and Braithwaite (2001) showed that a small number of taxpayers actively seek out aggressive tax agents (that is, those that explore the loopholes in the tax law). In a follow up study, Murphy & Sakurai (2001) attempted to explain what led taxpayers to seek such advice. It was shown that those taxpayers who sought out aggressive tax agents placed less value on the tax system and the Tax Office. Compared to taxpayers in general, they were less likely to view the Tax Office as a legitimate institution and were more likely to disagree with Tax Office decisions. Thus, their tendency to engage in aggressive tax planning was seen to be a reaction toward an organisation that they perceived to be illegitimate.

Moving Forward

Since it moved to disallow deductions in 1998, the Tax Office's approach toward the tax schemes issue shifted in April 2001. Part of this approach included a communication strategy, designed to better meet the needs of taxpayers caught up in schemes. This strategy included organising regional visits by Australian Taxation Officers to provide face to face contact²⁰, allocating a case manager to each taxpayer with a scheme related debt, sending improved information to scheme participants, and promoting Tax Office helplines.

The Tax Office's new communication strategy appeared to incorporate many of the key features of procedural justice. However, for many investors the personal and emotional toll had already been taken and the Tax Office's attempts to encourage voluntary compliance among scheme investors appeared to fall on deaf ears. One explanation for why this might be the case is offered by Tyler and Smith (1998). They suggest that individuals do not rate procedures with surface features of fairness to be fair if they feel that those creating or implementing the procedures are not motivated to act fairly.

Due to continued resistance, in February 2002 the Tax Office offered its final concession to investors who were the victims of aggressive marketing and bad advice. This came in the form of a settlement offer, whereby penalties and interest on each scheme related debt would be abolished and investors would be given a two year interest free period in which to repay their debts. Investors were given until June 21st 2002 to decide if they would accept the offer. The settlement offer was initially met with further skepticism and resistance. However, with two key court cases being won by the Tax Office in February and May 2002, many investors saw the offer as a way to finally put the matter behind them. At June 21st 2002, 87% of the investors had agreed to settle (Source: Tax Office correspondence).

The Tax Office appears to have won their battle against the scheme investors. Sadly, however, investors no longer appear to trust the Tax Office and it will be interesting to see

whether their future compliance behaviour has been affected by this experience. It is acknowledged that re-engaging disgruntled taxpayers is no easy feat and future strategies (for example, advertising campaigns, targeted letters, restorative justice techniques) that encourage scheme investors to voluntarily pay their fair share of tax in the future may go a long way to reducing their future involvement in the tax minimisation industry.

New Tax Office Initiatives

While there is no clear and easy solution to the problem of aggressive tax planning, it can only be hoped that the Tax Office can learn from the experiences of the past to ensure that a situation like this can never happen again. Preventing scheme involvement in the first place is likely to be the most appropriate strategy. This is because, unfortunately, no cure to a problem such as this is ever going to be viewed as fair by all taxpayers. The Tax Office appears to share this view, as indicated through the recent introduction of the Taxpayer Alert system. The Taxpayer Alert system is an early warning system designed to alert taxpayers to the Tax Office's concerns about significant new tax planning issues and arrangements. Taxpayer Alerts are published on the Tax Office's website (www.ato.gov.au) and they warn taxpayers and tax advisors that the Tax Office may not agree with the benefits being claimed by particular arrangements.²¹

As noted earlier in this paper, one of the major criticisms of the Tax Office's dealing of the mass marketed schemes issue was their delay in making the decision to crackdown on tax avoidance schemes. In some cases it would take years for the Tax Office to publicly release position papers or rulings on particular schemes.²² Although the Taxpayer Alerts are not the Tax Office's final or concluded view on an arrangement, they briefly describe the features of an arrangement that concern the Tax Office. Thus, the significant advance

²⁰ Although there was no evidence to suggest that regional visits had occurred.

²¹ Surprisingly, the attitude of tax professionals toward helping the Tax Office prevent scheme involvement has been negative.

²² For example, between 1987 and 1994 the Tax Office investigated 14 schemes and disallowed deductions in nine of them due to their use of limited- or non-recourse financing. It was not until 1997, however, that the first draft ruling in relation to an investment scheme was issued (TR97/D17). Specifically, the ruling focused on the tax implications of certain financing arrangements.

that the Taxpayer Alert system has made over former Tax Office procedures is that it at least provides a warning to taxpayers about an emerging area of concern.

While the Alert List initiative will help prevent taxpayer involvement in scheme arrangements, it is not without its problems. Apart from needing access to the internet, it is possible that some potential investors may not be aware of the system. In addition, some investors may not use a tax advisor, or their tax advisor may lack the integrity to accurately inform them about the Tax Office's concerns about a particular scheme arrangement. In some cases, tax agents were reported to have been taking commissions from scheme promoters when they signed their clients up to a particular arrangement. Thus, the introduction of penalties for those who profit from promoting and marketing tax effective schemes would also help to prevent a re-occurrence. In fact, the Commissioner of Taxation recently indicated that legislation aimed at introducing financial penalties for the promoters and marketers of schemes would be considered. With many investors questioning whether action will be taken against the promoters and marketers of the schemes, a move to introduce legislation such as this may even restore some investors' perceptions that the Tax Office is a legitimate institution that is entitled to be obeyed. By pursuing the promoters, it will be seen by average taxpayers that the Tax Office does not only go after the 'little guy'.

It is also proposed here that the development of formal guidelines and accreditation or registration procedures for the professional conduct of tax advisers would be a step in the right direction (see Murphy & Sakurai, 2001, p. 20). Guidelines that aim to provide a safeguard for tax practitioners who feel pressured into developing clever strategies for minimising their clients' tax obligations, or to protect taxpayers from advisers who (1) may misinterpret their clients' wishes, or (2) lack the ability or integrity to prepare accurate and correct tax returns, may further stem aggressive tax planning. Without placing some onus of responsibility on the promoters, or even the professionals who assist taxpayers to prepare their tax returns, aggressive tax planning will continue to evolve and flourish in the future.

Conclusion

Overall, the findings of the present study demonstrate that the Tax Office's initial use of a punitive deterrence-based strategy can sometimes produce the opposite behaviour to that sought, and can in fact lead to taxpayers questioning the legitimacy of the organisation (see also Ayres & Braithwaite, 1992; Tyler, 1997). The Tax Office, therefore, will no longer be able to take its legitimacy for granted and might be wise to consider more closely the potential impact its decisions and procedures might have on future taxpayer compliance. The challenge for the Tax Office will be to acknowledge the importance of procedural justice in their dealings with future non-compliant taxpayers, and to make a commitment to implement and nurture feelings of justice and fairness amongst all its staff members. One obvious way this can be achieved is to encourage staff that deal with non-compliant taxpayers to genuinely adopt the principles underlying the Australian Taxation Office's Compliance Model (ATO Compliance Model). The ATO Compliance Model was first introduced into the Tax Office in 1998 and has been shown to be slowly permeating the psyche of many Tax Office staff (see Hobson, 2002; Job & Honaker, 2002; Shover, Job & Carroll, 2001). The style of enforcement emphasised in the model is to take into account the problems, motivations, and conditions behind non-compliance (Braithwaite & Braithwaite, 2001; Job & Honaker, 2002). Strong emphasis is placed on educating taxpayers about rules and assisting them in efforts to comply, while programs that rely principally on threats and the mechanical imposition of penalties are de-emphasized. By keeping punishment in the background instead of the foreground of a regulatory encounter, a tax officer is therefore more likely to gain cooperation with a non-compliant taxpayer (for a discussion see Ayres & Braithwaite, 1992).

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Appendix A

To date, three categories of mass marketed schemes operating in the Australian market have been identified by the Tax Office (Australian Taxation Office, 2000). These include, (1) round-robin schemes, including non-recourse financing, often in agriculture, afforestation and franchises; (2) certain film schemes, with guaranteed returns that are, in effect, a return of part of the invested funds; and (3) employee benefit arrangements that have tax benefits as their main purpose. It is only the first two types of scheme that are of relevance to the present study.

An example of a franchise scheme is 'Oracle'. Oracle offered investors the opportunity to invest in a business that promoted and presented personal development and educational workshops. By making an initial cash outlay of \$10 000 and borrowing \$30 000 from Oracle's financing company, investors could claim an immediate tax deduction of \$40 000. This would lead to some investors, depending on their original income level, to receive a tax refund from the Tax Office of up to \$19 400 (Source: Oracle International Pty Ltd Prospectus, p. 3). From here, \$10 000 of the \$19 400 went into paying the initial \$10 000 set up fee. In some cases, investors were able to 'pocket' the remaining \$9 400.²³

Several aspects of the investment were of concern to the Tax Office. One major concern was that the loan of \$30 000 was repayable only from the proceeds of the business. If the business made no profit, investors would not be required to repay the loan. Therefore, unlike many other investments (for example, negative gearing of property), there was no risk to the investor. In addition, some scheme investors made a profit from their tax return (in some cases the profit was as high as \$9 400). Another concern for the Tax Office related to the nature of the deduction made. Specifically, only a fraction of the \$40 000 claimed as a tax deduction went into the underlying activity. For many scheme arrangements, the majority of the money raised went into financing the management fees.

²³ It should be noted, however, that the majority of investors did not personally receive anywhere near this amount, or alternatively, they channelled the whole amount back into the business.

Appendix B

Definitions

Non- and Limited- Recourse Loans

In the Tax Office's view, a non-recourse loan is an arrangement where the lender has no recourse or right to reclaim the loan beyond a specified security of the borrower. Usually the specified security is tied to the scheme's earnings (for example, the sale of timber in afforestation schemes). In other words, with a non-recourse loan the borrower is not personally at risk to repay the loan, apart from the specified security.

A limited recourse loan exposes the borrower to slightly more risk than a non-recourse loan. Under a limited recourse loan the lender may have recourse to other assets of the borrower's, beyond the specified security. For instance, the borrower may be required to repay the investment loan in full, even if the income from the scheme is less than the outstanding balance on the loan.

Round Robin Financing

A round robin arrangement involves a circular paper flow where little real capital is at stake. It often involves, according to the Tax Office, the passing of documents such as cheques and promissory notes among connected parties, usually on the same day, with no change to the overall level of cash. While it creates the appearance of a financial transaction, there is little or no cash generated that can go into the underlying business of the investment.

Part IVA

Part IVA of the Income Tax Assessment Act 1936 empowers the Tax Office to deny or 'cancel' an investor's tax benefit where a reasonable person would conclude that the sole or dominant purpose for entering a scheme was to obtain a tax benefit. There are a number of elements that must be satisfied before Part IVA will apply:

- There must be a scheme;
- A tax benefit must be obtained in connection with that scheme;
- The scheme must have been entered into after 27 May 1981.

Product Ruling

Product Rulings are intended to provide certainty for potential investors by confirming the tax benefits of the investment. Unlike Private Binding Rulings, which apply only to an individual, Product Rulings apply to all participants in an investment. A Product Ruling only applies, however, if the arrangement is carried out in accordance with the information provided to the Tax Office.

Private Binding Ruling

Private Binding Rulings provide certainty on the tax benefits or consequences of an investment to individual investors. These rulings only apply to the individual taxpayer who requested the ruling. As with Product Rulings, Private Binding Rulings provide no protection in circumstances where the investment arrangement is not carried out in accordance with the information provided to the Tax Office.

**THE CENTRE FOR TAX SYSTEM INTEGRITY
WORKING PAPERS**

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