

**Inter-American Center of Tax Administrations – CIAT**

**45<sup>th</sup> CIAT GENERAL ASSEMBLY**



**“TAX MORALE AS DETERMINING FACTOR IN IMPROVING THE  
EFFECTIVENESS OF THE TAX ADMINISTRATION”**

**Subtopic 2.2:**

**“DESIGN AND IMPLEMENTATION OF CONTROL PLANS ACCORDING TO  
SPECIFIC BEHAVIORS”**

**Tax and Customs Administration  
The Netherlands**

**Quito, Ecuador  
April 4-7, 2011**

## **1. Introduction**

How does the behaviour of taxpayers play a role in the design of a tax authority's compliance strategy? The Netherlands Tax and Customs Administration (NTCA) focuses on the promotion of compliance. To this end the Administration implements strategies designed to influence the behaviour of taxpayers. This contribution explains the general principles of the NTCA's monitoring and the practical implications of these principles for the monitoring of large and small enterprises.

## **2. Compliance strategy**

The duties of the NTCA are to:

- levy, audit and collect state taxes, health insurance contributions, national insurance contributions and employee insurance contributions;
- audit compliance with legislation governing the import, export and transit of goods and with legislation governing the economic, health, environmental and safety fields, economic planning and financial integrity;
- award and audit income-related benefits;
- carry out investigations in all the aforementioned fields.

The NTCA carries out these duties with due regard for legal certainty, uniformity of policy and equality of rights.

The NTCA's general policy objective is expressed as follows: individuals and enterprises are prepared to fulfil their statutory obligations to the Tax and Customs Administration (compliance). Individuals and enterprises fulfil their obligations when they:

1. (justifiably) register to pay tax;
2. file their returns (in time);
3. file correct and complete returns;
4. pay the tax stated in the return (in time).

The NTCA's monitoring strategy is intended to increase the effectiveness of its actions and, at the same time, reduce the administrative burden associated with monitoring. The NTCA's compliance strategy assumes that the majority of individuals and enterprises wish to fulfil their obligations, a wish that is also demonstrated by the results from scientific studies. The intention is to encourage good behaviour, prevent errors and to update as necessary. The NTCA's actions are based on trust: when taxpayers betray this trust then the NTCA responds by increasing the stringency of its monitoring and taking decisive action. Section 3 of this contribution explains the NTCA's strategy and Section 4 the concept of horizontal monitoring. Sections 5 and 6 review the detailing of this strategy for large and smaller enterprises. Section 7 explains the theme-based approach to income tax returns and the last section, Section 8, contains the concluding comments.

### **3. Responsive enforcement: making choices**

#### **3.1. Definition**

The NTCA has opted for the strategy of responsive enforcement, whereby the Administration tailors its enforcement in all segments to the motives (willingness) and ability of taxpayers to comply with the regulations. The approach to enforcement depends on the motives.

Pursuant to the responsive enforcement principle, the NTCA forms an insight into the causes of non-compliance with the tax legislation and regulations. Taxpayers who usually fulfil their tax obligations and make an unintentional mistake deserve a response different from the response to taxpayers who knowingly and wilfully seek the loopholes in the tax regulations or make misuse of the manner in which the NTCA is organised. Responsive enforcement entails NTCA enforcement actions (monitoring) that are not focused solely on the rectification of past errors but also, and above all, address the prevention of future errors. From the perspective of taxpayers' future compliance, consultations with them on the prevention of errors in the future can be more effective than punishment.

The NTCA makes carefully-considered choices in its monitoring activities, firstly in terms of the cases that will be examined (and the cases that will not be examined) and, secondly, in the deployment of monitoring instruments.

Examples of these instruments include:

- the provision of information
- the provision of services
- communication on enforcement
- the provision of impetuses for amendments of the legislation and implementation regulations
- horizontal monitoring (in the form of covenants or other agreements with third parties)
- desk audits
- visible monitoring by means of tax surveillance
- criminal investigations

This palette includes both proactive and repressive instruments. The NTCA gives preference to instruments that provide for horizontal monitoring (in cooperation with taxpayers and based on mutual trust, transparency and understanding).

The NTCA has adopted this strategy since a purely repressive approach focused solely on the correction of past errors frequently fails to result in permanent improvements in behaviour or required changes in behaviour. However this does not, self-evidently, imply that monitoring is always horizontal. In addition to horizontal forms of monitoring, the NTCA also continues to deploy repressive instruments. When taxpayers betray the trust placed in them then the NTCA responds by increasing the stringency of its monitoring and taking decisive action, for example by means of adjustments, administrative penalties or criminal investigations. The Fiscal Intelligence and Investigation Service plays an important role in criminal investigations.

Providing clarity and transparency about the repressive approach makes clear that non-compliance with the tax regulations is unacceptable.

### **3.2. Segmentation**

The NTCA makes a distinction between individual and group client treatment. Individual client treatment is standard in the Medium-Sized/Very Large Enterprises (MGO/ZGO) segment, a segment which encompasses about 13,000 enterprises. Individual client treatment is not feasible in the Small and Medium-sized Enterprise (SME) segment in view of the size of the segment (about 1.2 million enterprises). Within the SME segment the NTCA makes a further distinction between starters, self-employed persons without employees (ZZP) and SME sector enterprises with employees (MKB-P). The total segment encompasses about 1.2 million enterprises.

## **4. Horizontal monitoring**

### **4.1. Introduction**

The NTCA's objective is to influence behaviour, with the focus on permanent compliance. NTCA develops monitoring instruments designed to provide optimum support to the achievement of this objective. Instruments focused on cooperation with taxpayers, relatively new additions to the NTCA's range of instruments, are referred to as "horizontal instruments".

The development of increased horizontalisation in monitoring is explained below. It is important to establish that the focus of the overall monitoring activities is placed on acceptable returns, i.e. returns that comply with the legislation and regulations and are free of material errors. Horizontal monitoring places a greater emphasis on the responsibilities borne by all parties in the preparation of acceptable returns, whereby it is important that enterprises an appropriate attitude, behaviour *and* implement adequate internal controls (in the collective approach in the SME segment the quality assurance of the tax intermediary's processes is of importance).

### **4.2. History**

The Scientific Council for Government Policy (WRR) published its *De toekomst van de Nationale Rechtsstaat* ('The future of law-based society') report in 2002, which the Council submitted recommendations on a more equivalent relationship between government and citizens in response to the changes in international and social relationships.

The government adopted the WRR's recommendations in its *Programma Andere Overheid* ('Modernising Government Programme', PAO). The NTCA began a pilot project at the beginning of 2005 which examined whether the monitoring of enterprises in the ZGO segment can be designed on the basis of the principles laid down in the PAO. In 2006, this pilot project was expanded to include the SME segment. The NTCA also gave an impetus to the enhancement of control with its *Toezicht dat ertoe doet* ('Monitoring that counts') programme.

At the end of 2007, a pilot project was also started for the MGO/OCK (Medium-Sized Enterprises/Other Complex Clients) sub-segment.

Horizontal monitoring has become the spearhead of the individual client treatment enforcement policy. Horizontal monitoring is also the preferred method of working in the other segments.

### **4.3. What is horizontal monitoring?**

Cooperation is the key to achieving quality in our modern society. The production chains in production processes need to be harmonised to guarantee short leadtimes, low costs and high quality. This is also applicable to the tax process: the entire process from transaction to return and assessment is an administrative chain in which the entrepreneur, tax service provider *and* the NTCA play a role. The NTCA's horizontal monitoring assigns cooperation a much more pivotal role. This in turn implies consultations in advance, as necessary, rather than audits in retrospect. It also implies making use of the quality within the chain, reaching agreements on the quality and avoiding the duplication of work. Consequently, horizontal monitoring pivots on cooperation – by each party on the basis of their role, but focused on the appropriate implementation of the tax legislation in an efficient manner *and* in a manner which ensures that the taxpayers know where they stand.

### **4.4 Key concepts and principles of horizontal monitoring**

#### Key concepts

Horizontal monitoring is based on three key concepts: mutual trust, understanding and transparency.

Transparency refers to complete openness by the taxpayer and the NTCA. The taxpayer is transparent about the taxpayer's tax strategy and the relevant tax issues (no [material] standpoints are adopted in filed returns that have not been discussed with the NTCA). The taxpayer gives open answers to all questions. The NTCA is open about the background to questions and the implementation of the Administration's monitoring. Constructive cooperation is possible only when both parties understand the position and (on occasion, conflicting) interests of the other party. Mutual, justified trust is necessary for the adoption of this method.

Trust between the enterprise, tax intermediary and NTCA is necessary since the parties' knowledge and/or information is unequal. If this inequality was not an issue then there would be no need for trust since there would be certainty. Consequently, trust is always accompanied by a form of uncertainty. The information that the NTCA does possess – the client profile – in combination with the enterprise's behaviour supports the decision to work with the enterprise on the basis of trust and justifies the acceptance of a degree of risk.

Pursuant to this method, the NTCA knows “less” about the facts and figures stated in the return, although this is justified since the Administration knows “more” about the manner in which the enterprise performs and manages its tax processes. It is important to realise that the NTCA observes behaviour and collects information during the horizontal monitoring programme that justifies the favourable expectations of the NTCA and the enterprise, and demonstrates that the trust given to the other party is justified. This enables the enterprise and the NTCA to establish that their trust in the other party is justified and that both parties are willing and able to assume their responsibility for compliance with the regulations.

## **Principles**

Pursuant to the aforementioned key concepts, the NTCA wishes to cooperate in the present with taxpayers (and the parties involved) in the maintenance and enhancement of compliance. This cooperation is given shape in the MGO and ZGO segments in the form of the conclusion of agreements (covenants) with individual taxpayers. The cooperation in the SME segment is based on collaboration with accounting firms, tax consultancies and sectoral organisations.

### **5. Influencing behaviour in individual client treatment**

#### **5.1. Introduction**

Clients in the medium-sized and large enterprise sector are treated on an individual basis. The tax affairs of these taxpayers are dealt with by a team of experts in the various taxes and in accountancy. A “client profile” is compiled for each taxpayer, a description of the enterprise, supported by an automated system, which contains information about the enterprise’s facts, circumstances and behaviour. The treatment team uses the current client profile to determine the strategy for the treatment of the client as based on the enhancement and maintenance of compliance. The taxpayer’s behaviour plays an important role in the client profile: changes in the enterprise’s tax attitude, behaviour and internal control influence the client profile and the treatment strategy is continually modified accordingly. The client profile, treatment strategy and client treatment jointly form a cycle. As stated above, the NTCAs prefers to base this strategic treatment plan on horizontal monitoring.

#### **5.2. The role of the taxpayer’s behavior**

Horizontal monitoring is based on the enterprise’s willingness to file acceptable returns. Within the context of monitoring an acceptable return is defined as a return that complies with the legislation and regulations and is free of material errors. Horizontal monitoring places a greater emphasis on the responsibilities borne by both parties in the preparation of acceptable returns, whereby it is important that enterprises exhibit an appropriate attitude, behaviour *and* implement adequate internal controls. This is manifested by the enterprise’s attention to and improvement of the internal control system, in particular the elements of the internal control system of relevance to tax issues, what is also referred to as the ‘Tax Control Framework’ (TCF).

The supervisory duties of the internal control departments and/or external experts are also of importance, since these duties contribute to the quality of the returns. In horizontal monitoring the relevant enterprise has expressed its intention to be transparent about observed (tax) points for attention, pursuant to which the enterprise agrees to actively seek preliminary consultations with the NTCA on these points for attention. In effect, these client contacts result in the continual development and enhancement of the trust between the enterprise, the relevant external experts and the NTCA.

The prior information received by the NTCA enables the Administration to adjust the form and intensity of the monitoring since the NTCA continually receives up-to-date information about the internal control processes and can observe that the enterprise actively shares points for attention.

The enterprise's approach to the preliminary consultations – together with the results from those consultations – jointly determines whether the entire return is acceptable.

### **5.3. Client profile**

The following elements can be of relevance to the specification of the client profile:

- What is the client's return and payment behaviour?
- Are any notices of objection being dealt with and are there any procedures or prior consultations in progress?
- Is there an insight into the enterprise's attitude to tax contacts (audits/prior consultations/objections)?
- Who are the tax consultant and independent auditor and what is their role in the tax contacts (audits/prior consultations/objections)?
- What is the concern structure? Do changes regularly take place?
- Does the enterprise employ sufficient financial and tax staff?
- Who are the members of the Executive Board and the Supervisory Board? How is the management effected?
- What are the enterprise's operations and known tax points for attention?
- What does the annual report contain (key figures, tax strategy)?
- Which type of auditor's opinion has been issued?
- Is there already an insight into the degree of the enterprise's tax control?
- For clients with international transactions within the concern: Can the transfer pricing documentation be used to improve the insight into the enterprise?
- Which other supervisory bodies are involved with the enterprise?

### **5.4. Behaviour during the horizontal monitoring process**

1. Preparations: willing and able

Following meetings with the enterprise and a study by the NTCA the Administration and

enterprise decide whether they are willing and able to work in accordance with the principles of horizontal monitoring. Any past unfavourable experiences with the client, where relevant, do not give reason to refrain from initiating horizontal monitoring: on the contrary, since these can actually offer opportunities for horizontal monitoring. Once the joint willingness and ability has been established the next important step is to settle any current issues for as far as is possible, such as current audits, current returns and notices of objection that are still being dealt with. The enterprise and the NTCA map these issues and reach agreements on their resolution, whereby mutual understanding and trust once again play an important role. Once the parties have agreed that cooperation on the basis of horizontal monitoring is feasible they conclude a covenant which specifies that the enterprise and the Netherlands Tax Customs Administration are going to cooperate and how they are going to cooperate.

## 2. Administrative organisation and internal control

Once the covenant has been concluded the enterprise and the NTCA cooperate on the administrative organisation and the internal control processes. The enterprise bears the primary responsibility for this work: the NTCA encourages and supports the enterprise, and gives feedback on the manner in which the tax processes, in particular, are controlled. The NTCA is then governed by the requirements imposed by the tax legislation and regulations. The degree to which the NTCA monitors the enterprise and the intensity of the monitoring depends on the degree to which the enterprise is in control.

The NTCA assesses the enterprise's degree of control, whereby the NTCA, in consultation with the enterprise, gives preference to statistical random sampling. One of the important elements of the degree to which the enterprise is in control is the NTCA's confidence in the enterprise's ability to identify tax risks in good time and to submit them to the NTCA. Any such risks are submitted before the return is filed so that they can be resolved as quickly as possible during the preliminary consultations or can be submitted to the court (agree to disagree).

## 3. Adjusted monitoring

Once these phases have been completed the NTCA has an insight into the enterprise's processes of tax relevance and the manner in which the enterprise controls these processes. The NTCA also has an insight into the work carried out by external parties (accountants, consultants, etc.). The NTCA tailors its monitoring to the degree and manner in which the client arranges for acceptable returns. This monitoring is detailed in the strategic treatment plan for the short and medium term (five years), whereby the enterprise cooperating in the horizontal monitoring process receives information about the substance of the plan.

## 5.5. Evaluation

The enterprise and the NTCA need to maintain an insight into any changes in the circumstances of either party, since these can be of influence on the initial horizontal monitoring agreements. In addition, the enterprise *and* the NTCA need to discuss each



other's experiences: this is compatible with the form of cooperation and is included in the agreements laid down in the covenant. The NTCA periodically determines whether the trust given to the enterprise remains justifiable.

### **Changed circumstances**

The prevailing circumstances at the time of the horizontal monitoring meeting, exploration of compliance and the conclusion of the covenant can subsequently change.

Changes can occur at the NTCA such as:

- changes in policy;
- changes in the members of the treatment team.

These changed circumstances can be of importance to the enterprise and can have consequences for the mutual trust. For this reason it is beneficial to confirm this trust when any such changes occur.

Changes can occur at the enterprise such as:

- changes in the market conditions;
- changes in the strategy;
- management of shareholder changes;
- changes in de administrative organisation or legal organisation (the relocation of company divisions, mergers, takeovers and demergers);
- changes in the tax department or at the tax consultant;
- changes of auditor or other external experts.

These changes can have an influence on the enterprise's attitude, behaviour and/or tax control and, consequently, on the NTCA's client strategy.

### **Experiences**

Favourable experiences confirm the trust in the other party and for this reason it is beneficial to state these experiences explicitly. When experiences give cause to doubts then it is important, from the perspective of repressive enforcement, to begin by sharing these doubts with the enterprise and jointly determine the factual situation.

In practice, enterprises will occasionally make mistakes and, consequently, fail to report a tax issue or file a return that is not acceptable. The NTCA can also make mistakes. However, a mistake does not automatically imply the total loss of trust. When the NTCA observes that an enterprise has made a mistake then the Administration needs to exhibit an adequate response (with understanding) by holding a meeting to discuss the causes of the mistake and the measures that have been implemented to prevent a repetition.

Mistakes can be made for many reasons: for example, the enterprise was not in control (and, consequently, was also unaware of the potential point of dispute, the enterprise assumed that the issue did not need to be discussed with the NTCA or, in an extreme situation, the enterprise deliberately decided not to be transparent. The NTCA will, depending on the outcome of the discussions, review the consequences for the client profile and the relationship of trust.

When the NTCA concludes that the enterprise's intention was and still is good then the relationship of trust can be restored by NTCA's exhibition of understanding and, as the occasion arises, the enterprise's implementation of appropriate measures.

When it transpired that the enterprise deliberately committed a breach of trust then the NTCA works through what is referred to as an 'intervention pyramid' or 'escalation ladder'. The intervention is responsive and is based on the intention, the circumstances, the severity and the frequency of the breach of trust. The intervention can be comprised, in ascending sequence, of the following:

- explaining or refining the agreements on attitude and behaviour (such as a renewed review of the principles of horizontal monitoring);
- temporary additional monitoring;
- corrective action (with a penalty, where relevant);
- terminating the agreement (the covenant).

Every intervention needs to be followed by an analysis to determine whether the behaviour has been improved and the client strategy can be adjusted favourably for the client.

## **6. Influencing behaviour in the SME segment**

### **6.1. Introduction**

Individual client treatment is not feasible in the Small and Medium-sized Enterprise (SME) segment in view of the size of the segment (about 1.2 million enterprises in the Netherlands). Nor shall a tax control framework in the form of that implemented by a large enterprise usually be in place.

The NTCA strives for a group treatment in this segment, pursuant to which the focus is no longer placed on the return of an individual taxpayer but on the returns of groups of entrepreneurs or the behaviour of sectors or other shared characteristics of groups of taxpayers. The NTCA adopts this approach by seeking cooperation with tax intermediaries. These service providers, such as accountants and tax consultants, play an important role in the design of the accounts, the internal control processes and returns of enterprises in this segment. The NTCA actively involves the tax intermediaries in its monitoring of the SME segment.

## **6.2. Cooperation between tax intermediaries and the NTCA**

Individual covenants are not concluded for the SME segment: instead, the NTCA reaches agreements with tax service providers. This cooperation, in analogy with the individual covenants, is based on mutual trust, understanding and transparency and is focused on the quality of tax returns. The NTCA and the tax intermediary conclude a covenant on the return process and harmonise their methods. During the preparations for the covenant the Netherlands Tax and Customs reviews the tax intermediary's internal quality assurance system.

Returns filed by the tax intermediary are referred to as 'covenant returns' and are acceptable to the NTCA. The NTCA settles covenant returns quickly: this increases the legal certainty. The cooperation with tax intermediaries limits the NTCA's need for monitoring to meta-monitoring: pursuant to meta-monitoring, the NTCA monitors random samples of covenant returns. Any inaccuracies in the design of the intermediary's processes are then, in a manner fitting to the horizontal relationship, discussed by the NTCA and tax intermediary in an open and transparent discussion.

All covenants include an agreement stipulating that the tax intermediaries submit relevant (tax) standpoints they have adopted or plan to adopt to their permanent contact person at the NTCA as soon as possible. This relates to issues that may be subject to a difference in opinion on the part of the NTCA, such as a difference in the interpretation of facts or the interpretation of legislation. The tax intermediaries enter into a commitment to actively provide the NTCA an insight into all facts and circumstances, their adopted standpoints and the (associated) legal consequences. The NTCA states the Administration's perception of the legal consequences as soon as possible after the receipt of a standpoint that has been or will be adopted, whenever possible in consultation with the relevant tax intermediary.

Each tax intermediary (or the association/federation to which they belong) and the NTCA meet at periodic intervals to discuss, in particular, the progress in the treatment of (new) tax issues. The tax intermediaries and the NTCA meet at least once a year to evaluate the performance of the covenant and update the covenant if so required. The tax intermediary and the NTCA hold regular meetings to discuss experiences. This approach (also) ensures that trust, understanding and transparency become material elements of the relationship between the tax intermediary and the Netherlands Tax and Customs. A third party is present in this relationship: the entrepreneur.

## **6.3. Entrepreneur**

The cooperation between the tax intermediaries and the NTCA offers the entrepreneurs affiliated with the covenant legal certainty on the quality of their tax returns. The entrepreneurs become affiliated with a covenant by submitting the requisite participation form to the tax intermediary. The entrepreneurs are required to conform that they shall submit their correct and complete financial accounts and other necessary information to the tax

intermediary in good time and that they wish to maintain a relationship with the NTCA based on mutual trust, transparency and understanding.

In analogy with the horizontal approach to large enterprises, in essence the entrepreneur and tax intermediary jointly create a tax control framework that can give the NTCA confidence in the quality of the returns. This in turn results in legal certainty for entrepreneurs due to the rapid settlement of their returns.

#### **6.4 Covenants with sectoral organizations**

The NTCA has also concluded covenants with sectoral organisations active in the small and medium-sized enterprise sector. Two options are available for cooperation with the sectoral organisations. When a sector is governed by a specific form of monitoring then this can result in the conclusion of a horizontal monitoring covenant. When a specific form of monitoring has not been implemented for a sectoral organisation then it is still possible to reach sectoral agreements on tax affairs. The latter form of covenants do not extend to monitoring agreements but make arrangements for the formation of a consultative platform for advance harmonisation of tax issues. An example of the latter is the covenant concluded with the inland navigation sector.

#### **6.5. The role played by behavior**

When returns audited in meta-monitoring are not acceptable then the nature and reasons for the errors are reviewed in consultation with the tax intermediary. The results from this analysis determine the modifications that need to be made to the return that was audited and/or in the work processes of the tax intermediary and/or the entrepreneur. The NTCA can intervene, as necessary, in the event of actions in conflict with the covenant. The tax intermediary bears the responsibility for the modification of work processes that resulted in errors.

### **7. Theme-based approach**

As is apparent from the above, the NTCA provides for the transparency of the Administration's monitoring approach. The NTCA always provides information about the monitoring approach adopted both for individual enforcement covenants and group agreements. In addition, the NTCA also strives to influence the behaviour of and promote compliance by the large group of taxpayers who file income tax returns.

A variety of instruments are deployed for this purpose:

- the provision of services
- the simplification of return processes
- pre-completed returns

Every year the NTCA devotes additional attention to a specific theme relating to the treatment of the income tax returns. This theme is announced in advance. With the 2010 return the NTCA increased the Administration's monitoring of the private use of company cars (in 2009, the NTCA devoted additional attention to the deduction for expenses incurred in the support of children under the age of 30; in 2011, the NTCA will devote additional attention to the filing of returns in time)

## **8. In conclusion**

The NTCA is focused on the promotion of compliance and to this end deploys instruments designed to influence the behaviour of taxpayers. This compliance strategy is based on justified trust and focuses on the advance provision of as much support and information as possible. It has transpired that retrospective monitoring and adjustment often fails to have a permanent effect on taxpayer behaviour. For this reason the NTCA has opted for the development of new instruments that can be deployed alongside the existing instruments.

The NTCA investigates the motives for non-compliant behaviour: these in turn determine decisions relating to the monitoring approach, firstly in terms of the cases that will be examined (and the cases that will not be examined) and, secondly, in the deployment of monitoring instruments. Preference is then given to the horizontalisation of monitoring, since this results in speed, up-to-date information, the prevention of non-compliance, legal certainty and the avoidance of the duplication of work. This contribution explains the approach to horizontal monitoring on the basis of the methods used in two segments, namely the largest and smallest enterprises.