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

Subtopic 2.3:

**“CREATING TAXPAYER AWARENESS: CORPORATE SOCIAL RESPONSIBILITY AND
THE FORUMS FOR TAXPAYER- TAX ADMINISTRATION DIALOGUE”**

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Abstract

Tax compliance can be increased by improving the way how tax authorities interact with taxpayers. The idea of building better tax morality and promoting corporate responsibility is developing world-wide, also in the EU Member States. This is based on an enhanced dialogue between tax administrations and taxpayers, and builds on mutual respect and cooperation. Taking into account the development of business models, an enhanced dialogue between a single national tax administration and a businesses operating in an international environment has, however, its natural limits. Therefore, in 2010, the European Commission has decided to both launch a public consultation and to establish a communication channel for tax authorities and business operators at an EU-wide level. The preliminary outcomes of this comprehensive stakeholder consultation are to a large extent in line with the above-mentioned practices regarding the enhanced dialogue at national level. The key findings suggests that the establishment of trust between tax payers and tax authorities, fairness, legal certainty, transparency, responsiveness can result in an increased efficiency for both taxpayers and tax administrations.

1. The necessity and way to build tax morality among taxpayers

Public administrations have responsibilities towards their citizens. The fulfilment of these responsibilities requires a significant amount of financing, and governments rely heavily - amongst others - on revenue generation through taxation. In the EU, VAT represents a major part of this tax revenue. Citizens as private individuals and business have to pay taxes; tax authorities have to collect them. The challenge is how to manage the tax system in a way to collect the revenue due in the most efficient way and with the least administrative costs. A key issue is taxpayers' compliance, but especially voluntary compliance is deemed to depend largely on intrinsic tax moral. The key question is, however, how to create this tax moral.

How to treat taxpayers in order to achieve an enhanced dialogue?

Tax compliance can be increased by improving the interaction between tax authorities and taxpayers. Compliance theory suggests that taxpayers tend to respond in a systematic way to how the tax authority treats them. In particular the taxpayers' willingness to pay taxes and the overall tax moral is raised when the tax administration acts respectfully. Conversely, when the tax administration considers tax payers in principle as potentially non-compliant persons who need to be forced to pay taxes, taxpayers indeed tend to respond by actively trying to circumvent taxation and pursuing tax avoidance schemes¹.

¹ Lars P. Feld & Bruno S. Frey Deterrence and Tax Morale: How Tax Administrations and Taxpayers Interact www.oecd.org/dataoecd/9/51/2789923.pdf

Theoretically, two diametrically opposite ways of treating taxpayers can be distinguished:

- a) An authoritarian treatment, undermining tax moral;
- b) A respectful treatment built on mutual trust, raising tax moral.

Tax authorities can define how they would like to balance the features of these two extremes and hence their very own approach in many different ways. In any case, these decisions will determine the relationship between taxpayers and tax administrations and consequently affect the level of tax moral.

a) The traditional "authoritarian" approach

On the one hand, when following the "traditional" authoritarian approach, the tax administration manages taxes instead of people. Per definition, the strategy will be to effectively control rather than to fruitfully cooperate. Taxpayers are expected to file tax returns and statements disclosing an amount of factual information, declare the right amount of tax due and pay this tax on time. The tax administration will ensure taxpayers' compliance by conducting ex-post audits and seeking more information about the tax return retrospectively.

Additionally, if necessary, the tax administration will also take enforcement measures to correct and collect the right amount of tax payable. Tax audits often have backblocks of 5 years and more. They usually result in a considerable number of queries regarding previous tax years, which is experienced by the taxpayer as an unfair fishing expedition. Due to the long lapse of time, the information requested by tax auditors is also many times difficult to obtain and therefore heavily interrupts the normal course of business. All this contributes to a culture of distrust between tax administrations and businesses. Generally, there is hardly any possibility for the taxpayer to get certainty in tax matters in advance. Due to the complexity of tax systems, taxpayers must in the absence of a constructive relationship with the tax administration often rely on external expertise, which further increases compliance costs.

Because of this "obligation based" nature of the relationship there is no incentive to disclose additional information to the tax authorities, particularly on areas of tax uncertainty or risk.

b) The enhanced dialogue

On the other hand, the idea of building better tax morality and promoting corporate responsibility is developing world-wide, and this development is also observed in EU Member States. It is based on an enhanced dialogue between tax administrations and taxpayers, and builds on mutual respect and cooperation. Key issues in these "new" compliance strategies are seeking to establish trust between tax payers and tax authorities, a fair balance between the rights and obligations, legal certainty, transparency and efficiency.

However the arrangement and implementation of these compliance strategies based on dialogue differ among countries, as they need to take into account the cultural environment, history and legislation. Existing relationships between tax authorities, taxpayers and tax intermediaries differ widely and the changes required to move towards an improved relationship will have to be adapted to the circumstances. The following paragraphs of this section aim to give a short overview of the main features of these new compliance policies based on the experiences in a number of EU Member States.

i) Building trust

Building a relation of trust will be a key issue driving cultural and behavioural change. The majority of people, businesses and institutions can and wish to be socially responsible. However trust is not something any party can simply acquire or require, it has to be earned and established. This requires a number of changes in administrative practices and should not be regarded as a short-term process.

First, building trust requires an open exchange between the tax authorities, tax payers and their representatives, in particular involving the trade associations. In order to establish such an open and collaborative relationship, many tax administrations have set up client relationship managers or one-stop contacts. Although this approach was initially designed for large taxpayers, it is more and more extended to small and medium sized entities (SME).

Second, trust requires mutual understanding and commercial awareness, particularly by the revenue authorities. Taxpayers will be reluctant to voluntarily disclose information if they fear that the tax authorities will misunderstand the information and use it in their disadvantage.

Third, trust requires fairness and an impartial approach by the tax authorities. This is mainly a matter of cultural attitudes. Measures that can contribute to fairness are alternative dispute resolution techniques such as arbitration, public service quality commitments, and certification campaigns for regional tax and audit centres. But also acknowledging the taxpayers' right to make unintentional mistakes and granting the possibility to submit voluntary amending tax returns with no or lighter fines should be regarded as a vital component of the new compliance strategies.

ii) Increasing transparency and voluntary disclosure of information

Both taxpayers and tax authorities are benefiting from more transparency and voluntary disclosure of information. The tax administration expects taxpayers to be fully transparent in their way of doing business and to disclose all significant risks in a timely manner.

Consequently, the taxpayer should disclose anything that he believes is of interest to the tax authority to undertake a fully informed risk assessment, or in other words, that accepts the responsibility to provide a self risk assessment. Internal control frameworks play an essential role in this context and some EU Member States even require, as a part of the enhanced dialogue, that the taxpayer develops a tax control framework, which forms then part of the

internal control system. However, while the internal control system involves the control of all business processes, the tax control framework focuses on the internal control of tax processes.

Naturally, the taxpayer expects his openness and transparency to be reciprocated by the tax authorities, and particularly an ongoing and open dialogue. This can address, inter alia, questions on why particular behaviour or tax positions are seen to be risk or why the tax authority is seeking particular information. But also other measures may contribute to meeting this transparency goal, such as early explanations of new laws, the provisions of guidelines as well as an open and constructive stakeholder consultation on changes in tax policy and tax administration.

This voluntary disclosure of information may be laid down in formal "Partnerships" agreements, emphasising that supervision is a shared responsibility by taxpayers and tax authorities.

iii) Legal certainty and responsiveness

One of the main benefits that taxpayers can achieve through an enhanced dialogue is legal certainty. This requires tax administrations to be commercially aware, transparent and to disclose appropriate information. Moreover one of the best ways to satisfy the taxpayers' need for legal certainty is to develop functioning and accessible advanced ruling procedures. As taxpayers need this certainty timely and quickly, these arrangements should be flanked with an obligation for the administration to respond within a specific length of time.

An enhanced level of trust, transparency and legal certainty will result in *an increased efficiency for both businesses and tax administrations*. On the one hand, the voluntary disclosure enables tax administrations to better, respectively more proportionately, allocate their resources and to pursue more efficient tax audit approaches, as audits could build on internal tax control systems previously implemented as a consequence of closer cooperation.

Moreover, the dialogue approach has the potential to avoid time-consuming and hence costly ex-post corrections and disputes. Consequently, it also entails an increased efficiency for the taxpayer, as it will reduce compliance costs and lead to simplified procedures. In the long-term, an enhanced dialogue has the potential to even contribute to an overall improved tax system with minimised administrative burdens for voluntary compliant taxpayers.

2. The change in business models drives the new relationship

New compliance strategies based on the features outlined in the previous section require tax administrations to regard the cooperation with taxpayers as a possibility to also adapt their possibly outdated approaches to a fast changing business environment. Mutual understanding and openness is crucial as business models have changed dramatically in the last decades due to both political and economic developments.

Whereas the “old business model” had more a local focus - local sales, little cross border, local accounting – is the “new business model” driven by technological developments and globalization as both has led to new products and (remote) services. Global markets require global sourcing and a global supply chain. Staying globally competitive means increasing efficiency through economy of scale driven by outsourcing/centralizing production, focussing on core business, outsourcing of supporting services/functions and increasing the use of subcontractors and service providers. The higher level of mobility has led to changes in logistics and to new transport capabilities allowing for stocks to be owned centrally but located locally for just in time deliveries (cross-border consignment and call-off stock).

Under traditional business models, it was effective for business to produce locally and sell locally. Even if the production site was in another country, business would first sell to a local subsidiary and such local subsidiary would sell to the local customer. Logistics worked in more simple models (usually supplies to stocks of the customers, inventory owned by customer). Cross-border services were even more uncommon.

Nowadays, businesses are operating in dynamic global markets and face global competition. Country borders are permeable, particularly for goods from low-cost countries. In fact, products which require a significant amount of human work-input will be produced in countries with the lowest working costs. Due to technological developments (particularly the internet), customers gain transparency and easy access to global markets. Particularly with regard to non-tangible services (e.g. download of software, music etc.), customers can virtually compare prices on a global level and can source such services from all over the world.

Also for SME the business model is changing, as they get more and more involved in cross-border transactions. For example, in the supply of goods and installation contracts (e.g. in the construction and heavy machinery industry) installation, repair and maintenance work is often subcontracted to both local and foreign SME.

3. Taking the EU VAT system as an example for an enhanced dialogue between tax administrations and taxpayers

Given the recent development and overall dynamic of business models, an increased cooperation between a single national tax administration and a multi-national business is, of course, of limited use. In the EU context, especially the relatively complex and harmonised VAT system offers considerable efficiency gains from a better cooperation of tax authorities with taxpayers. For cross-border tax issues involving more than one Member State, an EU level expert group was established in order to meet and facilitate the exchange of views on tax matters. This idea was firstly mentioned in the Commission's communication of 2008² and supported by many Member States in the 2009 Amsterdam conference on VAT fraud³. As a follow-up to the outcome of this conference, the Commission started the process to set up, a structured dialogue between tax administrations and business operators to discuss practical issues and possible means to improve the efficiency of the VAT system in view of reducing the administrative burden for business and tax administrations and combating VAT fraud in a more effective way.

Up to now, the focus in cross-border non-compliance was on legislative measures seeking to enhance the tools for tax administrations to combat tax fraud more effectively and efficiently.

Often, these anti-fraud measures have led to increased administrative requirements for compliant taxpayers as well. However, it was pointed out at several occasions that in an international context, business and tax administrations share a common interest and that business is very often willing to assist tax administrations in order to lower the joint costs of compliance. In this context, the development of a voluntary compliance strategy by means of a real dialogue between business and tax administrations is considered a promising step forward as part of the EU's VAT policy.

Furthermore, such cooperation also contributes to a smoother functioning of the VAT system as such. When business and tax administrations can have an open dialogue on problems in applying the fiscal rules encountered in daily practice, a win-win situation can be achieved. On the one hand, it can remove anti-fraud obstacles of the current VAT system which are redundant for compliant taxpayers. On the other hand, an increased dialogue reduces the administrative burden for business and tax administrations and offers the latter the possibility to allocate more resources to the targeting of non-compliant behaviour.

In general, there are three main benefits which can be achieved through a stakeholder consultation. First, securing the support and co-operation of the stakeholders in gaining the leverage needed to influence compliance behaviour. Second, contributing by means of a dialogue to a greater potential for strategies or measures envisaged to become workable and innovative. Third, securing, as a result of a dialogue, the authority's credibility and trustworthiness.

² COM (2008) 807 final of 1 December 2008

³ Fiscalis seminar "VAT fraud: a common concern for business and tax administrations " Amsterdam (NL) 23 January 2009

As a first step, the Commission has therefore initiated such a dialogue with business representatives in the framework of a so called "Business Expert Group on the smooth functioning of the VAT system in the EU". Fully set-up in 2010, this group is composed of 20 representatives of small, medium sized and large businesses.

This stakeholder consultation focuses on ways in which the relationship between taxpayers and tax administrations could result in a smoother functioning of the present EU VAT system.

Day-to-day practical problems arising from managing the VAT system are discussed, as well as suggestions elaborated for possible solutions. The focus of the group is on administrative and practical challenges and not on legal issues. Its main working areas are the following:

a) The practical challenges of doing businesses in past and present times

As outlined in the previous section, businesses operate in a highly international and dynamic environment as globalization and new technological developments have increased the complexity of their business models. The Business Expert Group aims to explore, on an EU-wide basis, the practical challenges businesses and tax administrations face in today's world. In doing so, it takes into consideration both the business and tax administration perspective and tries to foster a common understanding of today's practical challenges that both sides face.

b) Tax payer services, registration, transparency and disclosure of information

The first step a business has to do when carrying out activities outside their resident country is to work out whether these activities trigger a VAT registration or not. Since legitimate business is governed by its principle to be compliant and fulfill the different obligations in the respective country, there is a need for proper information regarding the respective rules and formalities in different EU Member States. The Business Expert Group aims to identify, share and support good practices of tax administrations for more transparency, fairness, legal certainty and simplification in the first step of the business cycle, namely registration. The aim is to eventually expand its working field to the whole business cycle.

The principal points of view expressed by the different stakeholders are to a large extent in line with the theoretical features of an enhanced dialogue mentioned in the first section of this paper.

- Both business and tax administrations need each other and have to cooperate in an open and trustful environment on both sides.
- Moreover it is considered as essential to gain mutual understanding and commercial awareness about the administrative and practical challenges which both businesses and tax administrations face in the current VAT landscape, with the aim to build a fruitful dialogue and cooperation between Commission, Member States and businesses.

- There is a need for a safe and fair VAT system to cope with today's complex business environment. The main factors to drive this are simplification, more consistent and standardized compliance practices across the EU, appropriate risk management processes and a fair and impartial approach.
- In order to facilitate compliance business need easy access to the relevant rules and administrative practices. When new legislation or a change in tax policy or in tax administration is introduced business need the appropriate lead time to implement the new legislation into business practice.
- Audit and control activities of tax administrations should be timely and risk management based. Internal control frameworks of taxpayers can play an essential role when it comes to this, as an enhanced dialogue can further reduce the duration of audits.
- Simplification and more consistent and standardized compliance practices across the EU are key instruments to increase efficiency and reduce costs. Modern technology can play an important role with respect to potential efficiency gains but it needs to be kept in mind that there might be no "push the button" approach and that this is hence only one factor required.

It is a future aim to widen this existing platform to tax administrations of the EU Member States, offering a possibility to share, discuss and – maybe - solve practical bottlenecks in the management of the VAT system. o This would help to smoothen the functioning of the system and generate benefits for both the tax administrations and the business.

The need for specific arrangements with stakeholders and their legal effects would also be considered in this context. For instance, consideration could be given on how to implement at EU level the idea of "Partnerships" (specific agreements between tax administrations and taxpayers). The possibility of ascertaining the tax treatment of certain transactions in advance is another topic that could be looked at in this context.

A first meeting of such a platform at EU-level is planned for 2011 and will focus on the challenges and opportunities for meaningfully changing the relationship between tax payers and tax administrations as well as possible ways forward to enhance tax compliance in international business.

4. Breaking it all down: the main arguments

Given the crucial role of business in the VAT system as unpaid VAT collector, the efficiency of their relationship with the tax authorities and the way the VAT system is managed will greatly affect the level of tax moral and influence the costs of administering the VAT system for both parties. This relationship has many aspects: it covers the information tax authorities obtain from the taxable persons via the reporting obligations imposed at EU or national level, the collection of the tax by the taxable person and its payment to the tax authorities, the way VAT is audited, but also the quality of information provided by tax authorities, the legal certainty they offer and the accessibility of the tax administration.

Regarding the relationship between tax authorities and taxable persons, new approaches have been developed. These are notably based on voluntary compliance, risk assessment and monitoring aspects with the aim of reducing the involvement of tax authorities and decreasing the administrative burden for business and tax authorities. This development has been accelerated in a number of EU Member States following a steady reduction of their human resources in tax administration.

The idea of voluntary compliance is already high on the agenda in some EU Member States and a regular dialogue with business representatives is crucial in this respect. In joint meetings, tax authorities and business representatives can discuss domestic tax issues at national level, ranging from proposals for new legislation to the implementation of adopted legislation and compliance issues, for instance regarding reporting obligations. Such a dialogue based on confidence and transparency increase tax moral and has proven to be fruitful and helpful in having legislation complied with in an efficient way.

