

# The Role of the Enhanced Relationship in the Current Crisis



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## 1. Introduction

Over the last year there has been unprecedented attention focused on the role of tax administrations in delivering the revenues that governments need. Much of this attention has been on the question of whether or not multinational enterprises (MNEs) and high net wealth individuals (HNWIs) pay the right of amount of tax. There has also been a renewed interest in tax gap analysis. Yet, in many countries governments are cutting back on the resources available to tax administrations and, at the same time, asking them to do more, including the delivery of expenditure programmes. This article places this current political debate on tax evasion and avoidance in a broader perspective of the changing relationship between tax administration, taxpayers and tax advisors.

It suggests that, despite the current focus on adopting a tougher stance on tax enforcement, effective tax compliance will only be achieved if it is combined with good taxpayer service and where there is a constructive and transparency

dialogue between tax authorities, taxpayers and their advisors.

## 2. Change in Attitudes on the Part of Tax Administrations

The traditional approach of tax administrations to tax compliance was very much focused on detecting and deterring evasion primarily by blanket auditing which were usually confrontational. Success was measured by the yield from these audits; the number of assessments made; the number of court cases won, or in some cases even lost; the extra revenue brought in. Most tax administrations were headed by either lawyers, with a natural inclination to litigate, or tax technicians that had worked their way up through the audit chain.

Tax administrations are now moving towards developing a more behavioural response to compliance : shifting towards prevention rather than just detection and non-compliance. Why this change? The reasons include:

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- ◆ recognition that the majority of taxpayers want to voluntarily comply and the tax administrations main task is to help them do that;
- ◆ taxpayers are becoming more assertive and insisting that they have rights as well as obligations;
- ◆ taxpayer segmentation, in the acceptance that different groups of taxpayers have different types of needs;
- ◆ a move away from a tax-by-tax approach to more of a taxpayer-by-taxpayer approach;
- ◆ most tax administrations, certainly in the developed world, are now under severe pressures to do more with less; and
- ◆ a recognition that the informal economy cannot be dealt with effectively just by stricter enforcement.

### 3. The Pressures on Tax Administrations

Over the last three decades, the role of tax administrations has changed. Tax administrations have become not just collection agencies but also spending agencies. Many are now responsible for implementing social programmes, for example, family credits and student loan schemes. Many governments also look to the tax administration to implement part of their structural programmes to exit from the crisis. Increasingly, tax authorities are taking on the role of regulators, for example, in the environmental area and dealing with illicit activities.

All of this has changed fundamentally the way that a tax administration operates, the profile of the staff needed and the political risks for tax administrations. Few citizens complain if their tax bills are late, but they complain loudly if their benefits payments are late. Some Tax Commissioners are ambivalent about this trend and we are beginning to see a reversal, with some tax administrations curtailing their functions as spending agencies.

Tax administrations now have to live in a global environment where MNEs operate as global entities, with more tenuous links to their own countries. They operate and plan on a global basis and this applies to their tax affairs. Similarly, the advisory

profession has become increasingly global. Nowhere is this process of globalization stronger than in the financial sector. Foreign exchange controls have largely disappeared; controls on inward and outward investment have gone.

Technology has enabled financial institutions to move vast sums of money around the world at the click of a mouse. Despite the challenges globalization poses for tax administrations, one should not underestimate the benefits of globalization: benefits for citizens; for governments; for business. But we must make sure that the costs and benefits of globalization are fairly shared.

This globalization of national economies poses new challenges for tax administrations, and they continue to operate behind national barriers still. We have also seen governments putting more pressure on tax administrations to reduce compliance costs for taxpayers. This is not new, but it has taken on a new dimension with the recognition that compliance costs can be a factor in defining the competitiveness of a country.

This new environment has, nevertheless, opened up new opportunities for tax administrations:

- ◆ new technologies which enable tax administrations to provide e-services to a wider range of taxpayers;
- ◆ software that makes it far easier for tax administrations and taxpayers to calculate the amount of tax due;
- ◆ acceptance that in a global economy there is a need for greater tax transparency and the elimination of bank secrecy as a shield behind which tax evaders can hide; and
- ◆ new opportunities for tax administrations to learn from the experiences of each other and to intensify their cooperation and coordination.

### 4. How have Tax Administrations Responded to these Pressures?

#### 4.1. Structural changes

Tax administrations have moved away from a tax-by-tax approach to an integrated approach to dealing with the taxpayers. Today, there are very few OECD member countries that have not

integrated direct and indirect tax departments and many have also brought in social security. For large taxpayers, we increasingly see that VAT, corporate income tax and other taxes are dealt with in a highly integrated approach, with many countries having relationship managers that are dedicated to a particularly large company. We have also seen the move towards the creation of independent revenue services, especially in non-OECD countries, and this has minimized political influence, encouraged a move towards a more realistic pay scale and also made a clearer distinction between policy formulation and policy implementation.

In addition, we have seen most tax administrations establish special units to deal with groups of taxpayers which are particularly important in terms of revenue contribution. Many tax administrations now have large business units and these are generally responsible for dealing with MNEs. A growing number of countries have created units which focus on HNWIs and some have specialized units to deal with small and medium-sized enterprises (SMEs). We can expect this to tendency towards taxpayer segmentation to continue.

#### 4.2. A new emphasis on risk management

Increasingly tax administrations are adopting a more sophisticated approach to risk management, which can be seen as part of the segmentation approach referred to in section 4.1. The basic idea is simple: by focussing resources on higher risk segments and taxpayers, tax administrations can make a more effective use of their limited resources. This requires a systematic approach to the identification, assessment, prioritization and treatment of compliance risks. Successful risk management requires:

- ◆ better access to information both domestically and offshore, and information that is needed to identify both low and high risk taxpayers;
- ◆ this, in turn, requires the ability to integrate information from different sources; and
- ◆ a communication strategy, explaining why a taxpayer is in the high risk category,

what are the criteria, and what are the consequences.

#### 4.3. A more behavioural approach towards compliance

This approach recognizes that the taxpayers' attitudes towards compliance are more complex than just being driven by the fear of detection. Behavioural scientists have developed a new approach, where the key idea is that those taxpayers who want to comply should be helped to do so, whereas the persistent evaders should be targeted for investigations and subject to strict penalties.

Under this approach taxpayers are segmented into the following four categories:

- (1) those who do not wish to comply;
- (2) those who do not comply, but will do so if the tax administration focuses on them;
- (3) those that try to comply but do not always succeed; and
- (4) those that are willing to do the right thing and end up doing so.

The implications of this new approach are that it generally enriches the tools available to tax administrations to achieve good compliance that go way beyond just enforcement. It encourages them to educate taxpayers on their rights and obligations; to put in place mechanisms to improve service; to move towards a more targeted enforcement activities.

#### 4.4. Putting tax compliance in the broader governance and/or social responsibility framework

For far too long tax administrators talked just to tax professionals, whether in the advisory community or in business. This is changing. Commissioners are now spending more time talking to Chief Executive Officers (CEOs), Chief Financial Officers (CFOs) and corporate boards. Getting them to see that good tax compliance should be part of their good corporate governance strategy, and this is not an easy time when the financial crisis is putting pressure on corporations.

The attractiveness of this approach is that it forces corporate boards to discuss more frequently tax issues and to take ownership of a company's

tax strategy. Boards are more likely than tax directors to weigh up the financial and reputation risks associated with an aggressive tax strategy against a potential saving in tax. Some boards may decide to continue to pursue an aggressive strategy, others may not, but at least the debate goes beyond just minimizing the effective tax rate.

When the OECD started to explore this new approach in its Forum of Tax Administration (FTA), many Commissioners were sceptical. Some countries had rules that forbid the Commissioner to go into a board room; some Commissioners were concerned about being accused of doing "sweet deals". And some felt that this was not part of their job description.

Not unexpectedly, there was also a reluctance on the part of the business community and the advisory profession. They argued that tax was just too complex to have the board engage in detailed discussion.

The corporate governance community, as represented in the OECD's Corporate Governance Group, was reluctant to make the link between good corporate governance and good tax compliance. But after five years of work by the FTA, things are changing. Increasingly, Commissioners are spending more time talking to board members and this has resulted in a move towards boards accepting they must respect both the letter and the spirit of the tax laws. A view reinforced by the recently revised OECD "Guidelines on Multinational Enterprises"<sup>1</sup>, which now explicitly refers to the need for MNEs to respect the spirit and the letter of the law.

This message has also been reinforced by the way in which civil society has taken up the issue of tax transparency and good tax compliance. And governments, both of the left and the right, have been responsive to these campaigns (the effect of the "Occupy Wall Street" and "Tax uncut" campaigns cannot be overestimated). Tax Commissioners and Tax Directors need to reflect on how they can operate in this new, more politically inclusive environment.

#### 4.5. The move to more tax transparency

Tax administrations have built on the political support from the G20 and other groups towards more transparency in taxation and the elimination of bank secrecy as a shield behind which tax evaders can hide. Tax administrations are putting in place voluntary compliance initiatives to encourage taxpayers to come forward and declare their assets held illegally offshore.

Other countries are putting in place tax amnesties. Some countries now require taxpayers to disclose uncertain tax positions. All of these initiatives recognize that we must deal with the legacy of the past if we are to move on to a new, more cooperative future.

We have also seen a tougher approach adopted towards aggressive tax planning with the G20 launching work on base erosion and profit shifting. Many governments have put in disclosure rules. Others have targeted not just the users of these schemes but also the promoters and many countries are using sophisticated communication campaigns to show why it is socially unacceptable to engage in these types of practices.

#### 4.6. Moving towards an enhanced relationship (cooperative compliance) approach

Behavioural change is always more difficult than legislative change. But now is the time to make a sustained effort to move from a "basic relationship" to what the FTA calls an "enhanced relationship" (See Box 1) or what is now called cooperative compliance. The enhanced relationship concept is founded on transparency and cooperation on behalf of taxpayers throughout the year and a highly collaborative approach between the taxpayer and the tax administrator. As such, it can be characterized as a form of voluntary disclosure: the taxpayer promises actively to notify the tax authorities of any issues with a possible or significant tax risk and to disclose all facts and circumstances regarding the issues without hesitation or reservation. In return for full disclosure the tax authority endeavours to provide timely advice on significant positions, taking into account real commercial deadlines when doing so. This

approach provides the taxpayer with increased timeliness and certainty and, hopefully, reduction in the volume of open issues.

#### BOX 1: ENHANCED RELATIONSHIPS

- ◆ A new cooperative way of building tax compliance
  - Moving away from a basic relationship Operating only by reference to legal requirements
  - Limited disclosure and no signs of uncertainty
    - Low levels of trust
  - Towards an enhanced relationship
    - Establishing and sustaining mutual trust
    - Disclosure and transparency from taxpayers
    - Revenue body approach based on commercial awareness, openness and responsiveness

So what could taxpayers and tax administrations expect to gain from such a relationship? Box 2 summarizes what business could expect and, while some companies have struggled to derive full value from the enhanced relationship in its formative years, the overall response from corporates has been very positive. The main advantage is greater certainty and predictability, two features that are very important in today's uncertain economic environment. "I would say that in a couple of the major jurisdictions, in which we do business, we have entered into these enhanced relationships, which are delivering significantly greater certainty and I would say, also significantly reduced cost" said one MNC tax director.

Box 3 shows what the gains for governments might be. Here, the key is transparency and a willingness to go beyond respecting just the strict letter of the law and a willingness of business to educate tax administrations on the realities of new business models.

What are the main obstacles in achieving this change in behaviour? Improving levels of trust and getting tax administrations and taxpayers to the point where they have sufficient confidence in each other so that they are each prepared to commit time and resources to moving their relationship onto a new footing are both key. Much depends on the attitudes at the top of the tax administration and in the boards of companies. The advisory profession also has a key role to play in facilitating the dialogue and acting as a bridge between taxpayers and tax administrations.

#### BOX 2 : GAINS FOR BUSINESS

- ◆ Certainty and clarity in the applications of the rules
- ◆ A joined-up coordinated service
- ◆ Awareness in revenue bodies of business compliance cost and of the need to focus on reducing this
- ◆ Commercial and business awareness in tax administrations
- ◆ Access to the decision makers in tax administrations
- ◆ Rulings systems or other real time mechanisms for speedy resolution of issues
- ◆ More customer centred, better coordinated activity within tax administrations
- ◆ Consultation on tax policy issues.

Moving to an enhanced relationship is not without risks, of course. Commissioners who embrace such a relationship may be accused of "going soft" on taxpayers - particularly in the current media climate - and vice presidents of tax may be accused of failing to maximize shareholder value through aggressive minimization of effective tax rates. There is also the shared risk that the change in attitudes will not go beyond the Commissioner office or the corporate board room and that neither side will devote the resources initially required to facilitate the necessary cultural change. The behavioural change also needs to extend down the chain of command to those that are engaged in audit activities, and this

communication between executive and field office has long been a source of frustration for tax administrator and taxpayer alike.

**BOX 3 : WHAT TAX ADMINISTRATIONS WANT FROM ENHANCED RELATIONSHIPS?**

- ◆ Transparency and disclosure by business
- ◆ Respecting “the spirit of the law”
- ◆ Volunteering information which may highlight significant differences of opinion on interpretation
- ◆ Open and transparent dialogue
- ◆ Cooperation in tax risk assessment
- ◆ Assistance in understanding business and in developing commercial awareness
- ◆ Assistance in understanding governance and risk management systems in the business
- ◆ Tax issues considered at Board level and accepted as a dimension of good practice in corporate governance.

I believe the time is now ripe for a new push forward to achieve a more mature attitude towards tax compliance: one that accepts that this need not be a “you win, I lose” situation. In some ways the current crisis may help since in a very uncertain economic environment most CEO’s and CFOs would probably welcome greater tax certainty and an ability to resolve tax issues before they become tax controversies.

So now is a very good time for companies to consider engaging with tax administrators to ensure that the processes supporting the enhanced relationship are designed to meet the needs of both business and government.

1. OECD, Guidelines on Multinational Enterprises (OECD 2011), available at [www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/oecdguidelinesformultinationalenterprises.htm](http://www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/oecdguidelinesformultinationalenterprises.htm).