Changing the dynamics of the relationship between Tax Administrations and Taxpayers

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1. Introduction

In recent years, and particularly since the global financial crisis, there has been an unprecedented focus on whether multinationals (MNEs) are paying the right amount of tax. If not, what kind of measures are needed to secure fairer tax outcomes? These questions are vitally important to developing countries. On the one hand they are least able to afford the tax lost as a result of aggressive tax planning by MNEs. On the other hand MNEs are an important source of inward investment for developing countries and help them to grow their tax base, through regularised employment, payroll taxes and the collection of indirect taxes and excise duties. This article discusses some of the current initiatives designed to address tax abuses and aggressive tax planning. It highlights the growing importance of transparency in supporting improved tax compliance. It examines the possible implications of these new initiatives for MNEs and for tax administrations, especially those in developing countries. The co-operative compliance model may offer a means to reconcile two apparently contradictory goals: securing the tax revenue that should be due from MNEs, while also improving the business climate so that MNEs continue to invest in, and help grow, the economies of developing countries. This article places the co-operative compliance model in the broader context of current efforts to curb and prevent base erosion by MNEs, especially in developing countries.

2. Base erosion and profit shifting practices on the increase

So what does "base erosion and profit shifting", or BEPS for short, really mean? The first part of the notion refers to the erosion of national tax bases and the second to one of the reasons for that erosion. Corporates in order to pay less taxes use a number of schemes to shift their profits to countries with low or no taxes.[3] The impact on developing countries is arguably the most severe since without stable revenues, they are not able to provide infrastructure and essential public goods (education, health care, security and the rule of law) to their citizens.

The phenomenon of profit shifting is not that new. Back in 1961 President Kennedy noted that: "Recently more and more enterprises organised abroad by American firms have arranged their corporate structures aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices [...] in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad."[4] What is new is the scale of profit shifting and

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[3] Patrick Love, BEPS: why you're taxed more than a multinational, February 2013. Available online at: http://www.oecd.org/forum/what-the-beps-are-we-talking-about.htm.

[4] Quoted by Pascal Saint-Amans, Raffaele Russo, in What the BEPS are we talking about? Available online at: http://www.oecd.org/forum/what-the-beps-are-we-talking-about.htm.

this is partly the result of policies adopted by some governments that have actively encouraged profit shifting.

Harmful tax competition and the part it has played in encouraging aggressive tax optimization schemes was widely discussed in the 1990's. In 1998 the OECD published a report on the issue: "Harmful Tax Competition: An Emerging Global Issue". The report sought to distinguish between acceptable and unacceptable tax competition. It did so by identifying the essential features of harmful preferential tax regimes. These were: no or low effective tax rates, "ring fencing" of regimes, lack of transparency, and lack of effective exchange of information. Later, the Forum on Harmful Tax Practices (FHTP) was created by the OECD to support fair competition and minimise tax induced distortions of investment flows.

In 2000, the Bush Administration encouraged the OECD to refocus the project on tax transparency and exchange of information on request but many elements of the 1998 report, particularly the attention paid to ring fencing and the subsidiary criteria for identifying harmful regimes set out in the report, remain relevant today. However, in the 2000's the focus of attention shifted to intangible assets, as an increasing number of MNEs were moving these into low tax jurisdictions along with a significant share of their overall profits. In response the OECD initiated work to examine how the OECD transfer pricing guidelines should treat such intangibles.

While the discussion of aggressive tax planning and its causes predated 2008, the global financial crisis gave it a new urgency and a much higher public profile. Large-scale increases in governments' deficits, recession and falling revenues made governments much less tolerant of tax avoidance by MNEs. For ordinary citizens, who were being asked to pay more taxes and accept cuts in public services, tax avoidance by "rich" MNEs, many of whom they believed were responsible for precipitating the crisis in the first place, was simply unacceptable. Inevitably this had considerable influence on national and global tax policy and by 2009 corporate tax avoidance had become a regular topic on G8 and G20 agendas.

The public profile of BEPS was increased by two other developments.[5] There was a growing awareness that in some developing countries politicians and senior officials taking decisions about the taxes and other government's charges payable by MNEs were doing so with their own private and political purposes in mind. At the same time the media began to focus on the methods MNEs were using to reduce their tax bills, resulting in unprecedented media exposure of what Bloomberg's called "The Great Corporate Tax Dodge".[6] The mounting discontent of civil society with these schemes has been fed by NGOs that have highlighted case studies of tax avoidance involving some of the poorest countries in the world. In making these schemes intelligible to the non-specialist there has been a tendency to oversimplify the complex tax issues involved.

The impact of BEPS on public revenues and public confidence in the tax system as a whole is a major concern for all countries. Nonetheless, developing countries face particular challenges when they try to counter these activities. They are often less well equipped to deal with highly complex tax avoidance practices. They suffer from resource constraints in their tax administrations and/or a lack of technical expertise. Given that, aggressive and abusive schemes may have a significant negative impact on their ability to mobilise resources for

[5] J. Owens, Tax Transparency: The New "Normal", Revista da Receita Federal, Estudos Tributarios e Aduneiros, vol. 1, no. 2, 2015.
[6] Y. Brauner, What the BEPS?, p. 2.

sustainable development. According to UNCTAD, developing countries loose about $100 billion tax revenues annually due to inward investments being routed through offshore financial centres.[7] Although the practice of routing investments through offshore financial centres is common for MNEs operating in developed and developing countries, it has much more detrimental effects on the finances of developing countries. According to some estimates, if the share of total inward investment into a developing country that originates from offshore financial centres increases by 10%, the overall rate of return from foreign direct investment in the country as a whole is reduced by as between 1 and 1.5%. By comparison, in developed countries the impact is much lower (0.5-1.0%). Moreover, the analysis of recent trends reveals that the exposure of developing countries to investments from offshore centres is on the rise, while in developed countries it has been shrinking in recent years.[8]

To better understand the scale of the challenge facing developing countries it is interesting to compare the resources available to address a key aspect of BEPS, namely transfer pricing. It is estimated that Ernst & Young alone employs over 900 professionals to advise on transfer pricing and help clients to plan. The US tax authorities employ about 500 full-time inspectors to pursue transfer pricing issues whereas Kenya can only afford between three and five tax investigators specialising in transfer pricing for the whole country.[9] This disparity in the resources available leaves developing countries at a major disadvantage.

3. BEPS Action Plan: the G20/OECD set of policy tools

The Base Erosion and Profit Shifting (BEPS) Action Plan[10] consists of fifteen action items with deadlines for deliverables. It was published in July 2013 by the OECD under the auspices of the G20 Leaders. It reflects the priority now attached to the issue by the leaders of the G20. The BEPS Action Plan addresses the most difficult issues confronted by the international tax regime in recent decades.[11] These include: transfer pricing, inconsistent entity and instrument classification, the rise of the digital economy, the increasing number and complexity of disputes and the limited effectiveness of existing anti-abuse rules. The BEPS Action Plan builds on the conclusions of the OECD 1998 report and expands the role of the FHTP by committing it to "revamp the work on harmful tax practices." Its outputs are expected to be completed by December 2015.

The BEPS Action Plan calls for fundamental changes to current mechanisms and adoption of new approaches in order to counter base erosion and profit shifting. It aims to provide comprehensive, coordinated strategies for countries concerned with BEPS, while at the same time ensuring a certain and predictable environment for business.[12] Four main themes of the BEPS Action Plan can be identified. It aims to reestablish international coherence to corporate

[7] UNCTAD, United Nations Conference on Trade and Development, World Investment Report 2015. Reforming International Investment Governance, hereinafter: WIR 2015, p. 200.
[8] UNCTAD, WIR 2015, p. 199.
[9] Patrick Love, BEPS: why you're taxed more than a multinational, February 2013. Available online at: http://www.oecd.org/forum/what-the-beps-are-we-talking-about.htm.
[10] OECD, Action Plan on Base Erosion and Profit Shifting, 2013. Available online: http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/action-plan-on-base-erosion-and-profit-shifting_9789264202719-en#page1. Last viewed: 21.09.2015.
[11] Hugh J. Ault, Wolfgang Schon, & Stephen E. Shay, Base Erosion and Profit Shifting: A Roadmap for Reform, 68 Bull. Int'l Tax'n 275 (2014).
[12] Pascal Saint-Amans, Raffaele Russo, What the BEPS are we talking about? Available online at: http://www.oecd.org/forum/what-the-beps-are-we-talking-about.htm.

income taxation. It is going to restore the full effects and benefits of common international standards. It promotes transparency. And last but not least, it recommends swift implementation of the proposed measures.[13]

Transparency is an essential part of the actions proposed under this G20/OECD initiative. Improved and updated substantive norms on their own are not sufficient to guarantee effective curbing of aggressive tax planning practices. At the moment tax administrations lack information about aggressive tax planning and need tools to help them detect schemes early on. To counter aggressive tax planning governments need "timely, targeted and comprehensive information."[14] To the extent that aggressive schemes have relied on non-disclosure and involved jurisdictions with secrecy provisions, transparency in taxation is seen as a counter to the illicit and harmful behaviours of taxpayers.[15]

Among the BEPS Action Plan several of actions refer to measures introducing and enhancing transparency. Two of them: action 12 and action 13 are especially concerned with improved transparency in taxation.

Action 12, recommends the "design of mandatory disclosure rules for aggressive or abusive transactions". It is not the first time the OECD has focused on disclosure initiatives. In 2011 in the Report on Disclosure Initiatives the OECD Committee on Fiscal Affairs recommended examination of the disclosure of aggressive tax planning arrangements.[16] Among six different strategies the OECD proposed early mandatory disclosure rules. Action 12 is perceived by some as an amplification of the 2011 Report. Nevertheless, it goes further as it aims not just to encourage countries to introduce these rules but to make specific recommendations regarding their design. Mandatory disclosure rules can help tax administrations to address aggressive tax planning in three main ways.[17] First of all, these rules should ensure that tax administrations become aware of aggressive or abusive schemes much sooner than they do at the moment. Secondly, coupled with an effective exchange of information between tax authorities, they should help to prevent the propagation of schemes from one country to another. Thirdly, they will help tax administrations to identify arrangements that exploit mismatches between the tax systems of countries, to which they can apply the counter measures that have been developed as part of the other BEPS actions.

Action 13 is intended to "develop rules regarding transfer pricing documentation to enhance transparency for tax administration". It includes a requirement for taxpayers to report income, taxes paid, and indicators of economic activity in the countries in which they operate to government according to a common template (so called country-by-country reporting). It offers considerable advantages to countries. It will make it easier to identify cases where the value chain that their taxpayer is a part of involves entities in low tax jurisdictions that do not appear to have a great deal of substance, or add much value. Country by country reporting

[13] A. Cracea, OECD Actions to Counter Tax Evasion and Tax Avoidance (2013): Base Erosion and Profit Shifting and the Proposed Action Plan, Aggressive Tax Planning Based on After-Tax Hedging and Automatic Exchange of Information as the New Standard, 53 Eur. Taxn. 11 (2013), Journals IBFD.
[14] BEPS Action Plan, p. 14.
[15] L. D. Shoueri, M. C. Barbosa, Transparency: From Tax Secrecy to the Simplicity and Reliability of the Tax System, British Tax Review, Issue 5, 2013, p. 667.
OECD, Tackling aggressive tax planning through improved transparency and disclosure, February 2011, Available online: http://www.oecd.org/ctp/exchange-of-tax-information/48322860.pdf. Last viewed: 21.09.2015.
[17] P. Baker, 'The BEPS Project: Disclosure of Aggressive Tax Planning Schemes' (2015) 43 Intertax, Issue 1, pp. 85–90.

will be particularly helpful for developing countries by making it easier to identify when they are exposed to the risk of profit shifting.

4. Transparency as a countermeasure against aggressive tax practices

The call for greater tax transparency, reflected in the BEPS Action Plan, is part of a global trend for governments and wider civil society to demand greater openness from business. The BEPS Action Plan includes a number of measures designed to improve transparency that have already been discussed. But efforts to curb aggressive tax planning through greater transparency are not confined to BEPS. It is worth highlighting some of the other important developments that will increase transparency.

In respect of transparency in taxation, the move to automatic exchange of information has been a major breakthrough at the international level. It has been designed primarily to address tax evasion by wealthy individuals making use of financial accounts in jurisdictions that offered secrecy and low, or no, taxation. However, the move to automatic exchange will affect corporations and the burden of providing the data itself will fall on the world's financial institutions. The initiative was preceded by many steps designed to improve tax co-operation and all forms of exchange of information – on request, spontaneous and automatic. The Multilateral Convention on Mutual Administrative Assistance in Tax Matters and Article 26 of the OECD Model Tax Convention provided a basis for all forms of information exchange on request. However, in the wake of the US Foreign Account Tax Compliance Act (FATCA), it was possible to go further and move to a new standard based on automatic exchange of financial account information. The standard has been endorsed by the G20 Leaders on 19 April 2013 and was codified as the Common reporting Standard in July 2014.[18] It involves the systematic and periodic transmission of "bulk" taxpayer information by the source country to the residence country. The information concerns various categories of income (e.g. dividends, interest, etc.).

Alongside BEPS and the Common Reporting Standard, some industry specific reporting requirements have emerged. The Extractive Industry Transparency Initiative (EITI) was launched in 2003 and then revised in May 2013. It is designed to counter misappropriation of revenue, including taxes and royalty payments, paid by extractive industry MNEs to governments, in particular by oil, gas and mining companies. It promotes transparency in management of natural resources. Under the EITI Standard, business is required to report payments made to both national and local governments, including profit taxes and royalties. Participating governments have to disclose the payments they receive from companies, making it possible to compare what has been paid with what has been received.

At the national level many countries have taken steps to impose greater transparency. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)[19] is an example, with an impact beyond the territory of the USA given the importance of the USA as an investment market. The Dodd-Frank Act was crafted to bolster the stability of the US financial markets. The act includes several new regulations; among them special rules monitoring growing risks in the financial markets and rules addressing consumer rights.

[18] OECD (2014), Standard For Automatic Exchange of Financial Account Information in Tax Matters, OECD Publishing.

[19] The Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203, H.R. 4173). Available online at: https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf, last viewed: 20.09.2015.

Special sections covering non-financial companies that extract minerals, oil and gas were also included (Section 1502, 1503, 1504). Under Section 1504 of the Act the US Securities and Exchange Commission (SEC) was mandated to issue a rule requiring issuers engaged in the commercial development of oil, gas or minerals to annually disclose the amount of payments by type, by project and by government. The first rule issued by the SEC in 2012 required that SEC registered extractive companies filed an annual report with SEC which includes disclosure of all payments greater than $100.000 by the company, its subsidiaries or any entity under its control. This included payments to sub-national governments and "payments" included "taxes, royalties, fees (including license fees), production entitlements and other material benefits."[20] There were no exceptions to these disclosure requirements, which were publicly available. The rule issued by the SEC was, however, ruled invalid by the US federal court.[21] The SEC now has to propose a new rule implementing "publish what you pay" reporting under Section 1504 of the Dodd-Frank Act and has indicated that it may take until spring 2016 to do so.

The Dodd-Frank Act is not the only regulation imposing disclosure requirements on taxpayers in the USA. Certain taxpayers must now file an "Uncertain Tax Position Statement" alongside their tax return. The statement must include information about uncertain tax positions, which is a position taken on a tax return for which the corporation or a related party has recorded a reserve in its audited financial statements. It also includes instances in which a company has not recorded a reserve for the position because it expects to litigate it. The regulation is targeted at corporations that have assets of at least $10 million and are subject to certain other filing requirements.

A similar disclosure initiative was introduced in Australia. Under the so-called Reportable Tax Position (RTP)[22] schedule, taxpayers are required to notify three types of tax positions: a material position that is about as likely to be correct as incorrect or less likely to be correct than incorrect (where there is 50% or less likelihood of being upheld by a court), a material position in relation to uncertainty about how taxes payable or recoverable are recognised and/or disclosed by the taxpayer or in a related party's financial statements; and a position in respect of a "reportable transaction."[23] The obligation is imposed on specific taxpayers that the Australian tax administration has identified and notified. These taxpayers comprise those that have been determined to be either key taxpayers or "higher risk" (as categorised under the Australian Tax Office Large Business "Risk Differentiation Framework"). The regulation aims to oblige large businesses to disclose their most contestable and material tax positions to the ATO.

The Disclosure of Tax Avoidance Schemes regime (the DOTAS regime) is another transparency initiative introduced at the national level. It was legislated in the United Kingdom in 2004 and has been subject to several amendments. It requires promoters of certain types of tax avoidance schemes, or in some cases users of the schemes, to disclose

[20] Sec.1504 of the Dodd-Frank Act.

[21] The U.S. District Court for the District of Columbia vacated the rule and remanded it to the Commission in July 2013. For more details see: http://www.api.org/~/media/Files/News/2013/13-July/API%20vs%20Security%20Exchange%20and%20OXFAM.pdf.

[22] For more details see: http://www.irs.gov/Businesses/Corporations/Uncertain-Tax-Positions-Schedule-UTP.

[23] "Reportable transaction" includes a "position" where the taxpayer recognises more than $200 million of income in their financial statements and treats less than 50% thereof as assessable in that year; and the transaction involves a change in the effective ownership or control of an entity (or entities), business (or businesses) or asset (or assets).

them to Her Majesty Revenue and Customs. The scope of the DOTAS regime covers income tax, corporation tax, capital gains tax, national insurance contributions (NICs), stamp duty land tax (SDLT), annual tax on enveloped dwellings (ATED) and inheritance tax (IHT). One of main aims of this initiative is to keep up to date with what types of tax avoidance schemes are in circulation. This provides the opportunity to review and if necessary, amend legislation to block any scheme which the government considers aggressive and unfair. Those who fail to comply with the DOTAS regime are subject to a financial penalty.[24]

These are just a few examples of the best known transparency initiatives around the world. More are likely to be implemented following the finalisation of the BEPS actions and it is also likely that countries will create public registers of opaque entities.[25]

5. The implications for business

The current move to counter base erosion and profit shifting by introducing and enhancing transparency has a direct effect on business, and MNEs in particular. It is worth highlighting a few of the more significant challenges that business will confront as a result.

The clear trend towards increased transparency in all areas where government and business interact puts MNEs under pressure to disclose more and more information. The proliferation of reporting requirements at the national and international level will drive up administrative costs. Although companies are already obliged to disclose some data about the amount of taxes payable or recoverable under current accounting standards, it is clear that civil society now wants to see much more detail and new rules will reflect that fact.

The increased public attention to the tax behaviours of large corporates has already resulted in some reputational damage to MNEs. Nowadays, MNEs are perceived as not paying their way overall and as being particularly careless of their responsibility to pay taxes in developing countries. This can directly affect consumers' perception of the MNE's brand and their willingness to buy their goods and services. There is evidence that reputational risk is directly affecting the approach of some MNEs to tax planning. The issue of reputational risk is increasingly a priority for all companies as they think about their tax strategy. Starbucks is an interesting and possibly extreme example. Following controversy about its tax planning arrangements and an appearance before the UK Parliament's Public Accounts Committee, Starbucks agreed to make a "voluntary" payment of around £20m in taxes to the UK Exchequer over two years.[26]

Faced with increased disclosure MNEs need to ensure they have sufficient oversight of their global tax risks and practices to ensure that negative items do not come to light unexpectedly.

[24] For more details see: HM Revenue Service, Guidance Disclosure of tax avoidance schemes (DOTAS). Available online at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/457981/DOTAS_guidance_for_publication.pdf. Last viewed: 19.09.2015.

[25] Under the Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing each Member State has been obliged to set up registers that records the ultimate 'beneficial' owners of businesses. The new law has to be transposed by the Member States into national laws within two years from 26th June 2015. At the national level a public register has been proposed in the United Kingdom. Small Business, Enterprise and Employment Act 2015 introducing a register received the Royal Assent in March 2015.

[26] Vanessa Houlder, Skimping tax can still leave a bitter taste for coffee companies, Financial Times, June 16, 2015.

The higher standards of behaviour and transparency that are being imposed require large corporates to consider carefully how information that is put into the public domain may influence their reputation with customers, with governments, with suppliers and with their employees.

The final concern for business does not directly arise from measures to increase transparency but transparency may have the effect of amplifying the consequences. Inevitably, the new rules designed to counter the aggressive tax planning activities of MNEs, including the proposals resulting from the BEPS project, are complex and their application to particular facts and circumstances may not always be clear. There is plenty of scope for disagreement about the correct tax result, not just between taxpayers and tax administrations but between the tax administrations themselves. As a result many businesses are concerned that there will be a sharp increase in the number of tax disputes. These disputes will not necessarily result from non-compliance but could reflect a lack of legal certainty about the tax treatment of some transactions in the post-BEPS world. When the dispute is between tax administrations, the main objective of the taxpayer may simply be to avoid double taxation, rather than to secure any overall tax saving. Nonetheless, in a time of increased transparency, the existence of these disputes is more likely to be public knowledge and external stakeholders may assume it is evidence of ongoing tax avoidance by MNEs, whether or not this is the case. Avoiding the feared "tsunami of tax disputes" is consequently desirable in its own right and in terms of the reputation of large businesses as responsible corporate citizens.

6. Challenges for tax administration

It is clear that, while the new policy tools designed to assist tax administrations in their efforts to counter aggressive tax planning, including improved transparency, will be welcomed by them, they will also present them with some challenges. They will need to have the capability to make good use of the new information that will become available and police compliance with new standards. That may be a particular challenge for developing countries. Generally speaking, they are less well equipped to process complex data sets and recruiting and retaining technically able staff is often a challenge because of a lack of funding and the rates of pay available in the public sector.[27]

In addition to the resource constraints faced by tax administrations in most developing countries, a reliance on traditional command-and-control tax enforcement strategies may prevent those resources from being deployed as effectively as they might be. The traditional approach is based on an adversarial relationship between the tax administration and taxpayers. It is characterised by confrontation between the parties and a focus on enforceable obligations. There is a tendency to treat all taxpayers in the same way. Enforcement programmes are based solely on verification and coercive actions. The process of selection of taxpayers is less likely to be risk based, that is to say based on an objective assessment of past compliance and the likely exposure to tax risks inherent in the case.

The adversarial approach tends to increase the number of appeals and protracted disputes. These disputes are usually time-consuming and expensive.

[27] Report of the High Level Panel on Illicit Financial Flows from Africa commissioned by the AU/ECA Conference of Ministers of Finance, Planning and Economic Development, available online at. http://www.uneca.org/sites/default/files/publications/iff_main_report_26feb_en.pdf, p. 13, hereinafter: UNECA Report, p. 51.

Taking advantage of the opportunities that the BEPS Action plan will deliver will require new human and technical resources. Obviously, developing countries will wish to benefit from the consequent reduction in base erosion to secure the revenues they need to fund public services. But if they rely solely on coercive measures to achieve that goal, this may have the reverse effect if it discourages foreign direct investment.

7. MNEs as a critical source of FDI for developing countries

MNEs are a critical source of foreign direct investments for developing countries. The question is how can developing countries take action against base erosion and profit shifting to support domestic resource mobilisation but at the same time avoid creating barriers to productive investment?

MNEs play significant role in development. The last report released by UNCTAD demonstrates that foreign direct investment remains an important source of finance for developing and emerging economies. Over the decade to 2014, foreign direct investment tripled in the least developed countries and small island developing states. In the case of landlocked developing countries this number actually quadrupled. These data are mirrored in the contribution of MNEs to overall revenues and tax revenues. It is estimated by UNCTAD that the contribution of MNE foreign affiliates to government budgets in developing countries totals approximately $730 billion annually. It represents approximately 23 per cent of total corporate contributions and 10 per cent of total government revenues.[28] When one compares the relative size and composition of this contribution country by country, or region by region, it is evident that the less developed the country, the higher the dependence on corporate contributions.

Moreover, in addition to a greater share of tax revenues coming from MNEs, developing and emerging economies are also more dependent on MNEs in terms of non-tax revenues streams. Foreign affiliates contribute more than twice as much to government revenues through royalties on natural resources, tariffs, payroll taxes and social contributions, and other types of taxes, than through corporate income taxes.[29] As regards social contributions, personal income taxes and indirect taxes, the role of MNEs is instrumental as they assist in their collection. Nevertheless, it is of crucial importance in the context of developing countries that tend to have large informal economies.

Taxes remain important factor in the design of corporate structures used for cross-border investment. The traditional view of economists, shared by most people in business, has been that taxation is not a major, and certainly not the sole, determinant of decisions about the location of business activity. These decisions are driven more by potential long term profitability which in turn depends on factors such as costs, access to qualified labour, infrastructure, access to markets, and political and legal stability. However, tax does affect decisions about how to structure an investment (subsidiary, branch, joint venture) and how to finance it (locally, international, from headquarters or another subsidiary), since these decisions can be important for the repatriation profits. MNEs employ a range of tax schemes in order to exploit differences in tax rates between jurisdiction, legislative mismatches and tax

[28] J. Owens, Tax and Investment: UNCTAD Contribution to the ongoing BEPS debate, UNCTAD blog.
[29] WIR 2015, p. 181-182.

treaties. About 30% of cross border corporate investment is estimated[30] to have been routed through offshore hubs before reaching its final destination and form as productive assets.[31]

So tax administrations in developing countries have twin goals: to take the opportunity afforded by the BEPS Action Plan to secure higher and more stable tax payments by MNEs active in their territories, while also contributing to a business climate that encourages foreign direct investment and growth. The question is: how to reconcile these goals which appear to be in tension?

8. Co-operative compliance, improved compliance and business confidence

The co-operative compliance model may be the solution. It addresses at least some of the challenges that tax administrations in developing countries are facing. If well designed and executed, it is a highly effective and efficient compliance process.

The concept emerged on the international tax scene first at the national level in 2005 when it was introduced under the name of "horizontal monitoring" in the Netherlands. It gained wider recognition in 2008 when the OECD Forum on Tax Administration promoted it in its report "Study into the Role of Tax Intermediaries".[32] The 2008 report devoted a chapter to the notion which it described as an "enhanced relationship" between the taxpayer and tax administration. Later, in 2013 the OECD published a fuller discussion[33] of the thinking behind the idea and adopted the term "co-operative compliance". In part this was to avoid any suggestion that some taxpayers could obtain "enhanced" benefits that are not available to all.

Co-operative compliance represents a shift from a retrospective and primarily repressive control to a co-operative relationship between tax administration and taxpayers that is much more likely to involve the discussion of the tax treatment in real-time or even prospectively. It is intended to deliver quality compliance, which means payment of taxes due on time in an effective and efficient manner. At the heart of the concept is a simple exchange of transparency for certainty. The taxpayer undertakes to be wholly transparent about the tax positions they have taken in their return and the transactions that are likely to give rise to a tax risk. The taxpayer does not limit this disclosure to the information required by the administrative provisions of the tax code and does not seek to invoke legal privilege to prevent access to documents that may be relevant to the determination of a tax liability. In return, the tax administration agrees to offer the taxpayer early certainty about the tax treatment of the taxpayer's business transactions. Experience shows that this is often easiest to achieve if the discussion takes place as close as possible to the time when those transactions take place, which is why the co-operative model often encourages the parties to discuss issues before a tax return is even filed, or, in certain circumstances, before the transaction has taken place.

[30] WIR 2015, p. 190.

[31] However, in the current climate, tax certainty is increasingly important to MNEs. If the tax treatment of transactions in a country is highly uncertain that may have a greater impact on the decision to invest than the nominal rate of taxation.

[32] OECD (2008) Study into the Role of Tax Intermediaries. Available online at: http://www.oecd.org/tax/administration/39882938.pdf. Last viewed: 20.09.2015.

[33] OECD (2013) Co-operative Compliance: A Framework – From Enhanced Relationship to Cooperative Compliance. OECD Publishing.

Clearly trust between the taxpayer and tax administration is central to the effective operation of the co-operative compliance model but the OECD's 2013 report underlines that this trust must be justified. In particular, the tax administration needs to be satisfied that the transparency and disclosure of the taxpayer is underpinned by a system of control that ensures that the disclosure is complete and accurate. The core features of the concept which should be highlighted are: justified or demonstrable trust, transparency, co-operation, collaboration, voluntary disclosure, timely advice on significant positions, early legal certainty. The co-operative compliance model works on the basis that if a taxpayer is voluntarily and fully transparent, and able to show "how he does that", the tax administration should provide early tax certainty and do so in advance where appropriate.

The co-operative compliance model offers a win – win situation for taxpayers and the tax authorities. A taxpayer receives early certainty and overall should incur reduced compliance costs, whereas the tax administration benefits from a more efficient use of limited resources. Establishing the relationship may require some initial investment by both the taxpayer and tax administration but over time it will reduce the costs incurred by both. By discussing and resolving cases earlier, it is possible to avoid abortive enquiries and costly and time-consuming litigation, while directing the resources saved to higher risk cases. Moreover, both parties may benefit from certain reputational gains: taxpayers engaging in the co-operative compliance model demonstrate their willingness to pay their fair share of tax and the tax administration demonstrates a willingness to engage constructively with a key segment of its taxpayer population. This may explain why the co-operative compliance model has been adopted in one form or another in almost 30 jurisdictions worldwide.

The original 2008 OECD report identified seven pillars of the co-operative compliance model and the 2013 report confirmed their validity. Five of them concern the tax administration, whereas two deal with the taxpayers' approach to their tax obligations. Commercial awareness, impartiality, proportionality, openness and responsiveness are those required from tax administrations, whereas transparency and disclosure are what is expected of taxpayers.

Commercial awareness on the part of tax administration means they should have a good understanding of the commercial drivers that are behind transactions and activities undertaken by taxpayers. Tax administrations need to understand the broader context of an activity or transaction and respond in a way that minimises avoidable and potentially costly disputes and uncertainty. To these ends, tax administrations in some countries have established special units to deal with particular groups of taxpayers, for example taxpayers active in specific sectors, such as banking or mining, or of a certain size. Tax administrations adopting this model include some from African countries. For instance, in Botswana, Kenya, and Namibia a Large Taxpayer Unit or "taxpayer assistance centres" (Botswana) were introduced to enhance the relations with this particular segment of taxpayers. This type of organisational model certainly encourages specialisation by key administration staff in working with certain types of taxpayers, improving their understandings of a particular industry, or a certain business, and the tax risks it may pose.

The second feature which should characterise the actions of the tax administration is impartiality. Tax administrations are required to approach the task of issue resolution with a high level of consistency and objectivity. They should maintain a professional and critical attitude towards the large businesses they deal with and the information they obtain in the course of their dealings with that business. Failure to maintain impartiality will have a damaging effect on overall confidence in the tax administration and will undermine trust. To

address this risk, the governance process that the tax administration uses to ensure its decisions are soundly made should be transparent, even if the decisions themselves remain confidential. To ensure transparency about the decision making process, and the consistency and fairness of the decisions themselves, the 2013 OECD report distinguished six principles that should be observed in the governance of co-operative programmes. These are: integrity rules and core values, standard working programmes and operating systems, the involvement of a second (or even more) pair(s) of eyes in the decision making process, training programmes and programmes of regular contact between experts involved, rotation systems and review and monitoring systems.

Actions of the tax administration also have to be proportional. This aspect of co-operative compliance extends to the choices the tax administration makes in allocating resources and deciding which taxpayers, or which tax issues, to prioritise.

The last two aspects which should characterise the behaviour of tax administration within the co-operative compliance relationship are openness and responsiveness. Both attributes are likely to help establish a constructive relationship with taxpayers and make it much easier to work tax issues with the taxpayer in real-time. Real time working is the most effective way to achieve early certainty, which benefits both parties and is very valuable commercially. In the Netherlands part of the process of establishing a co-operative compliance relationship involves addressing and resolving any existing legacy of open tax issues. In Singapore there is a platform for large corporate taxpayers where they can discuss significant current events which have tax impacts with the tax administration so as to reduce downstream difficulties in assessments and objections.

As discussed, in the co-operative compliance model taxpayers provide disclosure and transparency. There has been some discussion of whether disclosure of the taxpayers' tax position should be structured as mandatory or voluntary but most co-operative compliance relationships are entered into voluntarily. The more pressing practical question is how does the taxpayer demonstrate that trust in their disclosures is justified? The practical response is that the taxpayer should have in place a robust process for managing, controlling and monitoring the correctness of reported tax positions. In other words, the taxpayer should have an internal control system that enables it to validate the outputs it provides to the tax administration. This system is known as the tax control framework. It is the cornerstone of co-operative compliance as it justifies trust between taxpayers and tax authorities. The two-pronged approach (tax control framework and the willingness to disclose positions voluntarily) has been fully integrated for example into the Australian framework. In Australia within the "Annual Compliance Arrangements with Large Corporate Taxpayers" programme, which is the ATO's co-operative compliance regime, two requirements have to be met. First of all, the large business has to have a sound tax risk management process and secondly, demonstrate a willingness to operate in an open and transparent relationship by making full and true disclosure of a major tax risks in a real time environment.[34]

Co-operative compliance enhances the efficiency and effectiveness of the overall compliance strategy and the audit programme by encouraging an approach based on tax risk management.

[34] For more details, see: Australian Taxation Office, Annual Compliance Arrangements with Large Corporate Taxpayers, The Auditor-General ANAO Report No.5 2014–15 Performance Audit, Available online: http://www.anao.gov.au/~/media/Files/Audit%20Reports/2014%202015/Report%205/AuditReport_2014-2015_5.pdf. Last viewed: 20.09.2015.

If the tax administration can rely on a taxpayer's disclosures, it can allocate its resources to other taxpayers that are not transparent and pose greater risk.

9. What does co-operative compliance offer to tax administration from developing countries?

The co-operative compliance model potentially offers many advantages to large corporate taxpayers and to tax administrations. It will encourage dialogue between these two parties and become the basis for establishing or restoring trust between the parties. There are certain benefits that are particularly important for parties from developing countries.

First of all, co-operative compliance encourages MNEs to be transparent on a voluntary basis. Not only is this valuable in terms of the taxation of the MNEs in the co-operative programme, it also helps tax administrations to acquire valuable data and commercial insights that will help it to detect, understand and address the tax risks posed by other taxpayers who are not part of the programme. So it should be possible to make significant savings of costs in handling the tax assessment of taxpayers within the programme, while also acquiring an appreciation of the tax risks associated with a certain type of transaction, business or a whole industry. This appreciation could be crucial in auditing and assessing the tax positions of other taxpayers.

Secondly, in return for the transparency of MNEs participating in co-operative compliance relationship, the tax administration provides earlier tax certainty. In general the tax administration will be better placed to give the business the certainty they need to make key commercial decisions. In the long run, this kind of relationship should give rise to fewer protracted disputes, which normally involves significant costs. Even if a dispute does arise and needs to be settled by the courts, it is much more likely to be limited to the correct interpretation of the law, as the facts should be agreed. The co-operative compliance model allows for the right to disagree and does not exclude the possibility of disputes as such, even if it will reduce their number. And when they do arise, they should be much easier to manage and resolve quickly.

Co-operation between tax administrations and taxpayers in assessing the correct tax liability helps both sides to establish mutual trust. From the perspective of the tax administration it constitutes trust in the full openness of the taxpayer and that that they will present all relevant facts and issues. From the perspective of the taxpayer it means that it will not be surprised by an unexplained change in interpretation of the law, additional and unexpected tax charges or burdensome audits. Justification of the tax administration's trust is provided by the taxpayer's tax control framework. Trust in the soundness of the tax administration's decisions is justified by its internal governance processes. Thanks to this justification, the overall tax outcome from co-operative compliance programmes can be demonstrated to be fair to external stakeholders.

MNEs are more likely to invest in a country where the tax administration offers a co-operative approach and early tax certainty. The stability and predictability of the fiscal environment in countries is an important factor in deciding where to invest, along with the tax administrative procedures and the ease with which tax obligations can be met. This can be as important as the actual amount of the tax burden. Compliance costs are an important factor in defining the competitiveness of a country and its ability to secure and increase inward investment.[35]

[35] J. Owens, The role of Enhanced Relationship in the Current Crisis, International Taxation, Vo. 8, 2013, p. 427.

The co-operative compliance model may have potential beyond the large business segment. Cumbersome legal obligations, legal uncertainty and lack of trust are likely to contribute to the size of the informal economy. Due to its nature, the informal sector cannot be dealt with effectively just by stricter enforcement. Under the co-operative compliance regime taxpayers might be more likely to abandon the informal economy and set up a constructive and transparent dialogue with tax administration.[36] It is particularly important from the perspective of developing countries, which quite often have a relatively large informal sector. Engaging with the SME community is much more challenging, just because of the number of individual taxpayers involved. Discussion of how that obstacle could be overcome is beyond the scope of this article but the increasing pace at which SMEs are automating their administration and that the payments they receive and make are being handled digitally offer tax administrations some exciting opportunities.[37]

10. Conclusions

Transparency is central to the effort to address and prevent aggressive tax planning schemes. Implementing the new rules that will result from the BEPS project could result in significant additional costs for tax administrations and taxpayers and a sharp increase in the number of tax disputes. All of which could lower levels of tax certainty.

Developing countries could suffer most from a deteriorating relationship between tax administrations and MNEs and an increase in disputes. They need to counter aggressive tax planning practices in order to increase their revenues but they also want to create a fiscal environment that encourages foreign direct investment. It is not likely that a reliance on traditional and coercive methods of securing tax compliance are capable of delivering these outcomes, or at least not on their own.

The co-operative compliance model may offer a solution. It requires MNEs to be transparent and ensures comparable transparency on the part of the tax administration, which is obliged to ensure the correct tax is being paid. It contributes to legal certainty as MNEs are informed at a much earlier stage about their tax position. It minimises the number of tax disputes and ensures that those that do arise are managed efficiently. In addition, it is based on the concept of "justified trust". Therefore, it delivers tax outcomes through a process that can be demonstrated to be fair to external stakeholders. It contributes to a climate that will encourage foreign direct investment. The introduction of the co-operative compliance model does not exclude the possibility of taking more repressive measures against taxpayers that continue to engage in aggressive tax planning that relies on non-disclosure. On the contrary, it makes it easier to focus enforcement activities on those taxpayers that pose a real tax risk. This ensures that the scarce resources of the tax administration are used in the most efficient manner.

Transparency is one of the main components of good governance. Co-operative compliance changes the dynamics of the relationship between tax administration and MNEs by requiring transparency from both sides. Effective tax compliance cannot be achieved by stricter enforcement alone. There is a need for a constructive and transparent dialogue between tax authorities and taxpayers. Being based on an even-handed and mutual obligation, the co-

[36] J. Owens, The role of Enhanced Relationship in the Current Crisis, International Taxation, Vo. 8, 2013, p. 423.
[37] OECD (2014), Tax Compliance by Design: Achieving Improved SME Tax Compliance by Adopting a System Perspective, OECD Publishing.

operative compliance model offers a means of achieving a high degree of transparency in tax administration for the mutual benefit of taxpayers, governments and the citizens they serve.