Receita Federal

40th CIAT General Assembly

Potential Collection as Goal of the Tax Administration

Florianopolis, State of Santa Catarina, Brazil
April 3-6, 2006

Inter-American Center of Tax Administrations
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PRESENTATION ON CIAT

Presentation on CIAT

CIAT is a public international organization established in 1967 to promote the improvement of the tax administrations through: exchange of ideas and experiences; technical assistance and training; compilation and distribution of information; and promotion of technical research.

The Center is formed by twenty-nine countries from the Americas, five European countries as full members and three countries: Czech Republic, Kenya and South Africa as Associate Members. The Minister of Finance or Treasury of each country designates the positions in his tax administration, the incumbents of which are the Representatives at CIAT.

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STATEMENT BY THE CIAT EXECUTIVE SECRETARY
DR. CLAUDINO PITA

Dear friends:

Dr. Claudino Pita

First of all, we would like to thank you for your kind presence and welcome you most cordially to this CIAT General Assembly whose main theme is the ever important and challenging proposal of "Potential collection as goal of the Tax Administration."

At the same time, we would like to thank the federal authorities of Brazil and the State of Santa Catarina for rendering possible the holding of our Assembly in this beautiful site and together with their tax administration officials, for having welcomed us with the traditional and well-known Brazilian hospitality and warmth.

Today we are evidencing once again Brazil's strong commitment to CIAT and its essential objective of promoting cooperation among the tax administrations of its member countries, a commitment that has always been evident through its support to the activities of our Center, since its establishment almost 40 years ago. Therefore, through our host, the Secretary of Federal Revenues, Mr. Jorge Rachid, we would like to convey our gratitude for all that Brazil has done, is doing and most certainly will continue to do, in favor of CIAT's development.

Following an extensive and well-oriented process through the years, we may now say that CIAT members are fully identified and committed to the principles and common objectives that inspired its creation. Nevertheless,

with a view toward the future and in order to preserve and strengthen such identification and commitment, it is ever more necessary to work together to successfully overcome new and important challenges.

In recent years, public and private organizations have experienced a transformation in the environment in which they operate, as a result of which there is greater uncertainty and interdependence. Since the world is immersed in globalization and digitalization, changes occur swiftly and unexpectedly and at times turn out to be chaotic and always dangerous for whoever is not mindful of them.

Such uncertainty and interdependency require that we strategically act and learn as we had never been obliged to do before. As for uncertainty, it is necessary to be watchful and interpret the signals of the environment or, better still, anticipate ourselves to them in order to define effective strategies. With respect to interdependency, we should endeavor to develop strong coalitions that may strengthen us and which, in turn, may facilitate the adoption and implementation of desirable strategies.

We have also learned that the transformations we have experienced are not merely evolutionary, but rather involve a rupture with the past, whereby the traditional planning tools, based on foresight and forecast and the use of historical data as starting point, represent a limited solution to respond to new challenges and to take advantage of new opportunities.

In the case of CIAT, in order to determine the course and contents of the desirable strategies, we would first have to ask ourselves what type of organization are we and where should we be headed. To this end, we would have to ask questions such as: Why and for what purpose do we exist? What topics should we consider and which should be the priorities? What activities should we carry out? Which ones not? Which values are important to our organization?

Allow me to attempt to respond to two of these questions in relation to CIAT.

With respect to why and for what purpose we exist, we would say:

Because the existence of CIAT implies, for the tax administrations of its member countries, counting on the joint support of those administrations that consider themselves similar as regards purposes and challenges faced and are willing to collaborate among themselves, which also allows them to cohesively insert themselves at the international level and thus be capable of defending their viewpoints and common interests.

Because beyond the institutional and operational strength that an administration may achieve, it is essential to count on references to identify their strengths and weaknesses and overcome the latter, which references may be obtained through the joint exchange and analysis of experiences promoted by CIAT in meetings such as this one.

Because through the works of CIAT, with the participation of specialists from several countries, best tax practices are analyzed, structured and documented and subsequently disseminated through CIAT publications. Some examples of them are the Tax Code Model, the Manual on the Structural Organization and Management of the Tax Administrations, the Tax Information Exchange Model, the Performance Indicators System, the Examination Manual, the Tax Policy and Technique Manual, the Tax Intelligence Manual, the Internal Control Manual, Information Exchange Manual and the International Tax Planning Control Manual.

Because the approximation and mutual knowledge among officials from different countries and administrations who share strategic and operational concerns regarding similar problems, allow the opportunity for directly finding alternatives and offering or requesting support for solving them, with CIAT acting as promoter and coordinator of such actions.

Because the scope of tax administrations for fully carrying out their control functions is limited to their respective territory and, it is difficult at times, and even when obtained, to determine the veracity of information on individuals properties or activities abroad. Therefore, it is necessary to count on the cooperation of other countries' administrations, which is promoted through CIAT and facilitated through the development of instruments as the aforementioned Tax Information Exchange Model and Information Exchange Manual.

Because the experience accumulated by CIAT through the technical assistance provided, in projects for strengthening tax systems and administrations, and its broad vision of world trends in taxation, ensure the member countries, in the formulation, follow-up and evaluation of such projects the support from an organization of which they are a part and wherein they participate in its management.

Because it is useful for the tax administrations to count on periodic information on the activities of similar organizations, as allowed by the portal in Internet and the CIAT Newsletter, in addition to accessing statistical data, as well as information on tax legislation from numerous countries through the CIAT Basic Tax Information System.

Because training programs offered by or through CIAT, especially the virtual courses represent a significant contribution whereby the participating officials may strengthen their technical knowledge and become aware of a broad range of alternatives for solving their managerial challenges, thus enhancing their role as agents of change.

All these actions and products made available to our member countries, fully justify CIAT's existence, especially if we take into consideration the fact that at CIAT, these same countries do not only use them to their advantage but also contribute to determine priorities and actively participate in their development.

With respect to the second question: which values are important to our organization, it could be said that there are at least three: equality, solidarity and respect for others.

Equality among all member countries as regards the standard application of the rules of our Bylaws and the opportunity for participating in the development and making of CIAT decisions. In the application of the principle of equality, comparable situations should not be treated differently, while situations that are different among themselves should not be treated in the same manner.

Solidarity, in the sense of unity among the tax administrations of our member countries which leads to a feeling of fraternity, of feeling affected by the scarcities faced by others, and through the attitude and decision to help them overcome those deficiencies. At this stage, it should be noted that since CIAT is an organization deeply rooted in the Americas, our priority commitment is toward the countries of the American Continent and the Caribbean, regardless of the fact that said same solidarity may be extended to other countries with less resources in other continents.

Respect for others implies nondiscrimination and acceptance of diversity, by focusing our attention on essentially tax-technical aspects. This is precisely one of the sources of CIAT's main strengths: cooperative coexistence amidst diversity. Allow me to further expand on this matter.

Although among the countries comprising CIAT there is no cultural, linguistic, geographical or historical homogeneity, which thus allows us to affirm that at CIAT, in that sense, diversity prevails, there is a coincidence and a will to walk and grow together. In addition, our experience indicates that as a result of that constant dealing with different traditions, perspectives, cultures and languages, such diversity has strengthened us by facilitating the knowledge and interpretation of the international environment and what is even most important, it has allowed us to understand and to learn to respect others.

Another positive aspect of management of such diversity is that, CIAT being an organization formed by countries with very different levels of economic growth (developed countries, emerging economies, and developing countries), the issues analyzed and consensuses reached stand out for their universality, as regards the way they are approached and the interests taken into account.

Given such evidence, in the past years, CIAT, without ceasing to be an essentially American organization, has deemed it convenient to gradually and strategically expand itself, by facilitating the incorporation of tax administrations from countries of other continents that adhere to our principles and objectives, in order to generate synergies, share concerns and seek solutions that may benefit all.

Currently, as a result of the considerations made regarding “why and for what purpose we exist”, and the important values of our organization, we are convinced that there are sufficient reasons to state that CIAT is on the right path and that the contents of the desirable strategies is more in keeping with the improvement of its strengths, rather than with the drastic changes in its structure or activities.

We may conclude that CIAT is a highly active and consolidated organization that counts on the effective support of its member countries and holds one of the most outstanding positions among organizations in the international sphere devoted to or beginning to act in the tax area; or even more so, the most exceptional in tax administration issues. At the same time, we wish to point out that one of our priority goals is to establish effective collaboration and coordination with those other organizations. Achieving such goal will allow us to direct the positive impact of our actions toward our real masters and beneficiaries; namely: the countries comprising our organization.

To conclude we wish to reiterate our recognition and gratitude to the Brazilian authorities, and likewise express our recognition and gratitude to the valuable team of officials working at the Executive Secretariat headquarters, consisting of international and local officials, as well as to the officials of the Spanish and French missions before CIAT, for their professionalism, spirit of service and commitment to our Center which, together with the support from our member countries has made and continues to make it possible for CIAT to be considered an organization with well deserved and indisputable international leadership in the area of taxation.

Thank you very much.

Official Photograph of the 40th CIAT General Assembly
"Potential Collection as Goal of the Tax Administration"

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April, 3-6, 2006

INAUGURAL CONFERENCE

Inaugural Conference

POTENTIAL COLLECTION AS GOAL OF THE TAX ADMINISTRATION

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SUMMARY

A strategic approach to a professional Tax Administration (T.A.) must necessarily go through three stages. First of all it must clearly define the ultimate objectives of the organization and quantify them. Secondly, it must design and structure the policies, that is, the actions to be carried out by the organization to achieve those objectives. To this end, there should be an express relationship between objectives and policies as well as a detailed development of the latter, in such a way that each member of the T.A. may be aware of his commitment and what is expected of him. Thirdly, there should be a follow up and evaluation of the policies so that each time we may select the most effective ones.

This is, in essence the structure of the lecture we will be presenting wherein, according to CIAT's proposed topic we have begun with potential collection as reference variable for the establishment of the objectives of any T.A., on understanding that its mission is precisely to ensure that citizens correctly comply with their tax obligations and to collect the corresponding contributions.

The portion of potential collection it cannot collect is the "margin of fraud", and thus, on setting the objectives of the T.A. we may say indistinctly that we endeavor to collect a specific proportion of potential collection or else, and this would be the say of expressing the same objectives, that we endeavor to reduce the margin of fraud so that it will not exceed a specific level.

Now then, if the T.A.'s objective is to reduce fraud, in order to design the corresponding policies it would be very useful for any tax administration to have the information available on existing fraud, the amount, where it is located, the profile of the defrauders, which are the means or instruments mostly used for evading, etc. Having all this information quantified is equivalent to having available an authentic fraud map that every T.A. should endeavor to develop regularly because without this information, the actions of the T.A. can only be inspired in the impressions or intuition of its agents based on their experience.

It is very necessary to have available a fraud map but, in my opinion, we should go even further. In addition to attempting to determine, the how much, where, how and whom of fraud, we should hope to find out the why if we want to design effective policies. We should try to find out in a systematic and strict manner the reasons that lead individuals to pay taxes or evade them. Only by finding out the variables that determine the taxpayers' behavior vis-à-vis the tax will we be able to develop consistent policies, which operating on those variables may urge them to improve their levels of compliance.

To this end, the lecture reviews several models of taxpayer behavior. In this field, difficulties are focused on the lack of information and from there arises the interest of regularly developing fraud maps. According to the basic model, taxpayer decisions are fundamentally based on two variables, namely: the probability that the evader may be discovered and the amount of the sanctions. There are other models that highlight the importance of non-economic variables, while the most recent ones pose the relationships between the taxpayer and the treasury in strategic terms. It is all right to be familiar with the existing analytical proposals and empirical studies –which are few- on the subject but, unfortunately this does not relieve any T.A. from carrying out this task, that is, to look for and develop the information and try to find out, in each case, the reasons that explain taxpayer behaviors.

If we are capable of identifying the variables that decide taxpayer behavior – of the different taxpayer segments – we may design the policies that are most appropriate for influencing such variables for the purpose of urging them to improve their levels of compliance. It seems reasonable to assume that there are different policies and that our interest will consist of selection the one or those that afford us the best results, bearing in mind the resources available. To this end, we should find out, on the one hand, what is the impact of each of these policies on the objectives and, at the same time, what is the cost. Having this double information available we could select the most effective policies.

These are indeed, laborious tasks that require an ongoing effort. However, they are necessary for any T.A. endeavoring to professionalize itself and acquire responsible commitments within the policy sphere

1. INTRODUCTION

The topic proposed by CIAT which is the main theme for this meeting is, as you all know, potential collection as reference objective for the tax administration (T.A.) and, given the introductory nature of my lecture, I would like to describe a guide of topics of interest for the T.A., that are closely related, as we shall see, with the use of potential collection.

Potential collection is equivalent to the maximum collection allowed, in each case, by the tax regulations in force. Said otherwise, it is the collection that a T.A. would obtain, if it would manage that all taxpayers, all individuals subject to tax regulations would correctly comply with their respective tax obligations. Accordingly, the greater the proportion of such potential collection actually collected, the greater, in principle, the effectiveness that may be attributed to the T.A. Thus, it may be said that potential collection is a guide to determine in a synthesized manner, whether a T.A. is improving or worsening its managerial capacity and also to compare the levels of effectiveness between different T.A.s.[1]

Therefore, it continues to be surprising that, in spite of the clarity of the idea, potential collection is not a variable commonly used as a reference objective. It is not even used as basis to establish actual collection objectives. What is customary is that T.A. objectives be established in terms of projected collection, estimated through any of the techniques available that in general,

[1] This type of comparison would be more appropriate if we would also take the costs into account, as we will se further on.

functionally relate actual collection with the evolution of the economic magnitudes that serve it as basis.[2] However, collection forecast made according to these terms, in our opinion, is not an adequate reference for determining the effectiveness of the T.A. since, by definition, type of projections is made by assuming that the economic variables, which are the independent variables of the function, are the only ones to vary. In some countries, even in the United States, this "ceteris paribus" hypothesis is explicitly developed, as regards tax regulations, by giving way to trend projections (base line) and the collection consequences of the regulatory changes that are being considered are estimated independently, as appropriate. With respect to the T.A., what is implicitly assumed is that it will not vary its levels of effectiveness, its management will be neutral, in terms of collection and it will maintain its levels of diligence. In sum, that its behavior will not influence the collection trend. Therefore, if collection objectives are established in those terms, we could say that the T.A., as organization would disappear and the reference for evaluating its behavior would be lost.

Perhaps that is the reason why some administrations resort to use as indicator of their effectiveness, that part of collection that is directly attributable to the administration's controlling activities. Thus, a significant increase of this component of collection is shown as indisputable evidence of the T.A.'s capacity to fight against fraud. And it might be so; but, of course, it could also be that it is totally the opposite.

In fact, when a T.A. uses the amount collected through control actions (investigation, examination, etc.) as evidence of its effectiveness and accordingly, establishes an incentive system, perhaps without being aware, it is aligning its interests to the interests of the defrauders since, the greater the fraud, the greater the possibilities of success for the T.A. On the other hand, to the extent the taxpayers voluntarily and faithfully comply with their tax obligations, there will be less opportunity for collection through administrative control actions. Indeed, what would interest the T.A. from this perspective is that taxpayers would fail to file or do so erroneously, concealing a significant part of their tax obligations, so that the administration's subsequent control action could bring about outstanding results. Therefore, it is in that sense we say that with such a scheme of objectives and incentives, the rational interest of the administration would favor the existence of fraud rather than its disappearance, which would

[2] Regarding the different techniques used for estimating revenues, one may consider, for example, "Description of CBO's Models and Methods for Projecting Federal Revenues," Congressional Budget Office, May 2001; and also "Overview of revenue estimating procedures and methodologies used by the staff of the Joint Committee on Taxation," JCT, February 2005.

constitute an inappropriate result as a consequence of the inadequate configuration of the objectives of the organization. The T.A.'s objective is not to maximize collection obtained directly through its control actions, but rather to ensure that all the citizens compelled by the tax law, correctly fulfill their tax obligations, which would again lead us to potential collection.

It must be said that it would not make sense either that the objective were to achieve a specific volume of collection without relating it to potential collection, since this would be equivalent to ignore the evolution of fraud. If this were not so, the most simple policy for achieving the collection objective would merely be to increase the applicable tax rates. However, fraud not only entails less revenues, but has at least two other important consequences. First, as we shall see further on, fraud may turn out to be contagious with the risk of exponential evolution and, secondly, fraud renders the legislator's will vulnerable, since it gives way to a different distribution of the burden than that intended by Parliament, both being circumstances that no T.A. can ignore.

There is little doubt that the objectives of any T.A. should be established on the basis of their potential collection and the simplest way of doing it would be as a proportion of said potential collection with which there would be, as usual, a quantum of volume of revenues to be obtained. Alternatively, we could arrive at the same result, by expressing the objective in terms of "margin of fraud". As we know,

POTENTIAL COLLECTION – ACTUAL COLLECTION = **MARGIN OF FRAUD**

that is, the margin of fraud coincide with the part of potential collection that has not been collected and, accordingly, when establishing the objectives for the T.A., it will make no difference to say, for example, that collection intended to be achieved is equivalent to 85% of potential collection, than to say that the objective is to reduce the margin of fraud to no more than15%. Both objectives are strictly equivalent.[3]

[3] Although similar, the "margin of fraud," as we have defined it, does not coincide with the "tax gap" calculated by the IRS. First of all because the "tax gap" is estimated on the basis of a sample of returns, for which reason its calculation only include what has not been declared by those who declare, disregarding all those who do not file; that is, the so-called underground or informal economy. Secondly, the "tax gap" includes payments owed and not made, while the "margin of fraud" does not consider payments, but exclusively debts earned.

In view of the above, perhaps we could ask ourselves why most T.A.s do not use potential collection as reference objective for determining their policies. We have thought about some reasons.

First, it must be admitted that it is not easy to calculate potential collection and much less at the level of differentiation required in its operation as we shall see immediately. It is a cumbersome task that even the most powerful administrations only perform from time to time. In addition to the undeniable difficulty of calculation, it must be said that some T.A.s are conceptually against doing it, since they fear that the evidence of a significant magnitude of fraud could, as we have just warned, discourage those taxpayers who reasonably comply with their tax obligations. Therefore, it would be better not to talk about fraud or those who incur therein, unless it were the case of defrauders who have been detected and punished so as to set the example, which logic could lead us by the hand to the corrupt behavior we have just denounced.

Finally, although of course not least, the use of potential collection as reference to set the objectives and determine the T.A.'s policies is a powerful technique, as we shall see, and also an extraordinarily demanding one for the administration. To accept potential collection as a guide and all its consequences with it, implies for the administration to involve itself in results and costs and that is something which is not easy to handle.

In spite of everything, we deem it is important that the T.A.s, to the extent they endeavor to operate as professional organizations, proceed to regularly determine quantitative estimations of the margins of fraud (what happens, as we have reiterated, as a result of estimating potential collection) as starting point, not only to establish a coherent series of objectives, but also to be able to derive adequate policies and criteria that may allow us to evaluate them. Les us then, see, in some detail, how all of this can be done.

2. POTENTIAL COLLECTION AND FRAUD MAP

If we accept that the main objective of the T.A. should be to approximate itself to its potential collection or, if preferred, to the elimination of the existing margins of fraud,[4] it seems clear that every T.A. should count on three fundamental aspects on which to base its actions:

[4] Although it could be thought that the ideal would be collect 100% of potential collection, this would not seem to make sense in practice. What is more, some might say that it is not only impossible, but not quite advisable, since reduction of fraud below certain levels could result in addition to ever more higher costs, in a tremendous pressure on taxpayers, even those who fulfill their tax obligations.

First. It should have a fraud map that would allow it to be aware of its amount and main characteristics.

Second. Based o the foregoing information, it should develop and compare several hypotheses of citizens behavior vis-à-vis the tax, so as to identify the main reasons that influence the decision of paying the taxes owed or evading them. And

Third. Based on the foregoing behavior models, one should design and develop the corresponding policies to combat fraud.

Only on the basis of this information could the T.A. decide appropriately decide the actions to be taken and prioritize them according to consistent criteria. If the fraud map were developed regularly, as it should be done, we could have available the necessary information to evaluate the effectiveness of the different policies.

Nobody is unaware of the difficulty of the task. However, even recognizing the difficulty, one must admit that the latter does not paralyze the daily actions of any tax administration which most of the time, acts by barely counting on experience and intuition. Now then, what we are saying is that to improve the design of its actions, its policies intended to reduce the existing levels of fraud, it is necessary to improve our knowledge of fraud and only thus will we have available the precise elements for structuring the adequate policies.

2.1. Calculation of the Margin of Fraud.

It is obvious that the difficulties for quantifying fraud are found in the estimation of potential collection and that such estimation will always provide an approximate amount. In the estimation of potential fraud and collection, generally two different techniques have been applied, which nevertheless, may complement each other.[5]

The first of the techniques endeavors to achieve potential collection of each one of the different taxes in an aggregate manner, based on information of nonfiscal origin. Given that the main taxes are applied to personal income, business benefits or family consumption, the information provided by national accounts on these aspects is frequently used. Of course, it is also

[5] This ordinance approximately coincides with the proposal by Frank A. Cowell in his book "Cheating the government. The economics of evasion," The MIT Press, 1990, p. 17 and subsequent pages.

possible to use other sources of information originating from statistics and reliable public or private registries.

What is done with this technique is to prepare a tax assessment based on the nonfiscal aggregate information available, on which the pertinent adjustments are made according to the provisions of the legal tax regulations. Let us imagine, for example, that it is a question of estimating the potential collection of VAT, a tax, which as we know, ultimately encumbers internal consumption. Now then, we have available an aggregate measure of that internal consumption through the national accounts. On its part, surveys on family expenditures provide us information on the structure of consumption, which may allow us to adjust the aggregate figure discounted, for example, exempt consumption and determine at the same time, the different consumptions of taxed good and services, amounts equivalent to their virtual bases, to which the corresponding tax rates could be applied for estimating the potential collection sought.

As we stated before, this form of operating, from the standpoint of our interest, poses a problem that limits its possibilities of use as an isolated technique and that is, that the calculation must necessarily abide by the information available of a nonfiscal nature which is the one that will set the limit of the results. It may frequently occur that the amounts of reference will be too aggregated and, therefore, results can hardly be use to guide the policies of struggle against fraud. What can normally occur through the use of this method is that there may appear very significant differences.[6]

There is another technique to determine potential collection and the margins of fraud that is more useful to our purpose because of the great level of detail it affords. It consist of taking one or several potential taxpayer samples and subject them to exhaustive verification by all pertinent tax concepts, determining thus, taxes owed which considered collectively would be equivalent to the potential collection sought. The margin of fraud for each individual of the sample would be the difference between the tax owed resulting from the exhaustive verification and the tax actually paid by that same taxpayer.

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[6] In the estimations made with the use of these techniques, the resulting margins of fraud which actually should be simply considered as differences between economic and fiscal amounts are usually around 50%. This was the amount determined in a work carried out in Spain ("Evaluation of fraud in Individual Income Tax in the 1979-1988 periods," IEF, Madrid 1988) which coincided with results in other estimations.
Actually, it is normal that it be thus since, in contrast to what occurs in the "tax gap" the "margin of fraud" also includes taxes originating from the informal economy.

That is, approximately, as we know, the technique used by the federal tax administration of the United States,[7] which affords a double advantage. First, it allows for determining some margins of fraud which, in contrast to what occurs with the previous technique, are susceptible of recovery by the T.A., if the latter has sufficient means available. Secondly, and this is fundamental for our purpose, it allows for obtaining levels of information that are much more significant with respect to the modalities, location and, above all, the causes of fraud. On the other hand, there is the inconvenience that the audited sample is limited to the filers, and thus the result will not show the amount attributable to those who do not file, even though they are obliged to do so. A simple way of remedying this bias would be to take the sample of taxpayers instead of the filers.

Although the two aforementioned techniques are the essential ones, one may also obtain quantitative information on fraud from tax amnesties. It is usual that the condoning of tax debts in an amnesty be conditioned to the declaration of the authentic tax bases by those who abide by it, something which can provide us a good measure of the existing levels of evasion. The problem with this measure is its exceptional nature, which deprives us of the possibility of having available regular estimations of fraud.

2.2. Different Perspectives of Fraud.

Through the complementary use of the two aforementioned techniques, fraud may be quantified from different perspectives. That is, by trying to respond to different questions in such a way that, it may be possible afterwards to combine the answers and thus obtain a map, as complete as possible. To obtain a measure of the total volume of fraud what is generally done is to calculate it in each tax, and even within each tax, the different items or categories taxed in order to precisely determine where fraud is located and, if possible, find out which means or instruments are preferably use in evasion. Along this same line of investigation, we should also attempt to find out how fraud is distributed according to economic activities and how it is done in the territory.

Going a step further, we could ask ourselves not only about the volume of fraud and its location, as we have done up till now, but also who are the defrauders, by trying to find out whether there are precise profiles based on their socioeconomic characteristics, in the case of individuals or else, the size or juridical nature, in the case of corporations.

[7] It is the well-known “Taxpayer Compliance Measurement Program” (TCMP) whose latest data correspond to 1988. More recently, the IRS implemented the “National Research Program” with a sample of 50,000 taxpayers with information corresponding to 2002 and whose results were scheduled to be published late last year.

It is also interesting to find out about the how of fraud. In an initial approximation it is worthwhile to distinguish, vis-à-vis the tax obligation, four basic answers from the taxpayer. (1) The first deals with compliance with his obligations and doing so in an appropriate manner. The second is, whether he declares, although incorrectly and here, there are two variants. (2.1.) One corresponds to those taxpayers who do not conceal or falsify the information provided to the T.A., although in the self-assessment, they erroneously classify the acts or businesses taxed, giving way to a lower debt than the corresponding one. In principle, we could assume that there is no intention to commit fraud, although this repeated behavior could lead us to another conclusion. (2.2) The second variant in behavior shows fraud behaviors. As compared to the previous case, there is concealment and/or falsification of relevant elements for determining the tax.

Finally, (3) in the last response one should include all those individuals who do not declare, even though they are obliged to do so. This is the case of taxpayers that do not exist for the A.T.

Counting on the different fraud perspectives and combining the information provided by all of them, we could undoubtedly develop a very important fraud map, that would allow us to identify where the main risks are found and guide administrative action in that direction.[8]

This being clear, I believe we should go a step forward. We should not only determine how much, where and whom, with respect to fraud, but also the why. We should endeavor to find out the reasons that lead a citizen to defraud or correctly comply with his tax obligations. That is, we should have some verifiable hypotheses about taxpayer behaviors vis-à-vis the tax, so that we may be aware, in each case, of the causes that determine their levels of compliance.[9]

However, given the scarcity of this type of information, other means have been used for obtaining taxpayer responses. One is the surveys applied to a group of taxpayers who are questioned about their tax behaviors and the

[8] From this optic, the OECD published an interesting document entitled “Compliance Risk Management: Managing and Improving Tax Compliance” in October 2004.

[9] In its reports, the GAO has insisted on the convenience of performing these studies. See, for example, among the most recent ones “Tax compliance. Reducing the tax gap can contribute to fiscal sustainability but will require a variety of strategies” (GAO-05-527 T), April 2005.

reasons therefor. The other means is laboratory experiments where the reproduction of actual situations is attempted to find out what would be the taxpayers' behavior in each case.[10]

3. MODELS OF BEHAVIOR AND DESIGN OF POLICIES

We must insist that only by finding out which are the determinant variables of taxpayer behavior vis-à-vis the tax, will we be able to design effective policies intended to reduce the margins of fraud. From there follows the great interest of any tax administration to examine the different models of taxpayer behavior and try to compare them with the information that may be provided by studies on fraud. What is more, as we move forward along this line and are capable of proposing clear hypotheses about taxpayer behavior, there will clearly be the need for information in a continuous feedback process.

As we have just seen, in the case of any tax obligation, the taxpayer always has the alternative of complying or not with said obligation through any of the aforementioned basic means.

The issue now raised and to which we would like to respond involves isolating the variables that, in each case, lead the taxpayer to opt for one alternative or the other because, only if we are capable of doing it, will we be able to design adequate policies for inducing defrauders to other orderly behaviors and likewise, reinforce in their decisions, those taxpayers that correctly comply with their tax obligations. In relation to these matter, in the past years several theoretical models have been developed, as well as to a lesser extent, given the scarce information existing, several empirical studies for the purpose of isolating such variables and trying to measure their importance in taxpayer decisions.

As we said before, there is certainly no single model that may be appropriate for all taxpayers, even though it may be only because their possibilities of evading differ widely. In our literature review of behavior models we have distinguished three categories. In the first one we should determine those

[10] On the use of this technique one may consider the work by I. Sánchez García and A. de Juan Chocano, "Experimental analysis of tax compliance" published by the IEF in its compilation of working Papers 2/1994. Also, the most recent one by B. Torgler, "Speaking to theorists and searching for facts: tax moral and tax compliance in experiments," Journal of Economic Surveys, vol. 16/5, 2002.

models that deal with economic variables; a second category of models includes behaviors based on the ethics of individuals and values and behaviors of the group; and, lastly, there is a third group of models that considers the relationship of the taxpayer with the T.A., in strategic terms that may be analyzed with the instruments of the games theory.[11]

3.1. The Basic Model.

The basic model of taxpayer behavior, of a rational and asocial taxpayer implies that the decision to pay a tax or not, results from the comparison between costs and benefits.[12] In its most simple presentation, the immediate benefit coincides with the amount due if we would fail to pay the tax; and the cost would be represented by the value of the risk assumed in that case, which is equivalent to the product resulting from the amount we would have to pay, if discovered (the fee plus the sanctions) multiplied by the probability that this may occur. According to this model, if the benefit were greater than the cost, the taxpayer would decide not to pay the tax; that is, he would decide to defraud, while he would be inclined to pay the tax in case the costs to be assumed were greater than the benefit.

There are three fundamental variables in the basic model that would explain the behavior of the taxpayers vis-à-vis the tax: its amount, the probability that the T.A. may discover noncompliance and the sanctions. Let us go over each of them.

As we have just seen, the amount of the tax is the immediate benefit to be obtained by the taxpayer who decided to evade. In a more elaborate presentation, one would have to add the costs of compliance which he could also avoid.

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[11] Those interested in an overview of these analytical developments may consult the work by J. Slemrod and S. Yitzhaki, “Tax avoidance, Evasion and Administration” included as chapter 22 in the “Handbook of Public Economics,” vol. 3, edited by A.J. Auerbach and M. Feldstein, North-Holland, 2002.

[12] The basic model was developed by Allingham, M. and Sandmo, A., “Income tax evasion: a theoretical analysis,” Journal of Public Economics, 1972.
A perspective of the development of the model since then, may be seen in the work of Sandmo, “The theory of tax evasion: A retrospective view,” Norwegian School of Economics and Business Administration, September 2004.

In this simplified presentation, an increase of the tax rates, with all other things being equal, would increase in absolute values the difference between benefits and costs and could encourage fraud, as the empirical works on the subject would seem to confirm.[13]

The second variable considered is the probability of being discovered (PBD). This variable tends to be associated to the probability of being audited, measured by the relationship existing between the number of audits performed and the number of taxpayers, a probability that normally shows very low values, not exceeding 5%.

Now then, if this is so, we could expect that no rational taxpayer, as implied by the model, would file his return since, with that PBD, in order to decide to comply with his tax obligations, the sanctions would have to exceed twenty times the amount defrauded, a level which, as we all know, is well beyond what is customary in tax legislations. And, however, it is obvious that the greater part of taxpayers acceptably fulfill their tax obligations. Should we then understand that the variables of the basic model are irrelevant? I sincerely do not believe this is so. I understand that other factors, other variables may intervene as well, but, of course, the variables of the basic model undoubtedly have great relevance and rather, their inadequacy in specific cases, is what should be explained.

Thus, in the first place the PBD of the model should not be associated, without any further consideration, to the relative number of audits. In any modern T.A. there are other instruments for verifying returns which even though lacking the power of the audit, are not irrelevant. Let us consider, for example, the withholdings and on account payment systems, the information crosschecks or the use of "results models" to select atypical returns. All of them are instruments that allow us to detect fraud and, therefore, increase the value of the PBD well beyond that 5% of audits.

Secondly, the PBD tends to be a case of asymmetrical information and, of course, it is frequent for taxpayers to extraordinarily overvalue this probability. The impression that every data in the hands of the T.A. or simply within its reach will actually be used in the verification of returns tends to be quite

[13] In the more formal models, the relationship between the tax rate and fraud ranges between the ambiguity and the surprising result that an increase in the rate of tax would increase the level of compliance. The empirical works, instead, indicate the contrary: that an increase in rates will encourage evasion with elasticity in relation to the income declared located between 0.5 and 3.0. See “Tax evasion” prepared by James Alm for the “Encyclopedia of Taxation and Tax Policy.”

common even in countries where the T.A. is far from having such capacity available.

Third, it is very evident that the PBD is not the same for all taxpayers. The PBD for an employee whose salary is subject to withholding is clearly very superior to that of a professional or small businessman. Thus, for example, in the case of the United States, it is estimated that wage earners subject to withholdings voluntarily declare 99% of their income, while in the case of independent workers, this proportion may even go down to 19%. Therefore, it is congruent that with the hypothesis of the basic model, the option to commit fraud is much more frequent among professionals and small businessmen than in the case of employees, as it actually occurs.

In sum, if we take into account all these circumstances, we may better understand the level of voluntary compliance without disregarding the hypotheses of the basic model.

The last variable considered in the model is sanctions. In their analytical treatment sanctions and PBD appear as interchangeable variables. Formally, then, the T.A. could decide to spend less by reducing the PBD and compensate it with an increase in the level of sanctions. However, from an applied perspective, very few would accept the substitution of both variables beyond close margins. And it is that neither for a T.A. or for citizens in general, the volume collected may be understood as independent from the distributive pattern. Evidently it is not the same to collect from all taxpayers in the same measure than to have extended fraud and a segment of taxpayers duly making their payments.

To the extent we understand and verify that the variables identified are determinants of taxpayer behavior, we may be able to design the most adequate policies to reduce the margins of fraud, policies which will be aimed at influencing those variables. In the case of the basic model, then, the policies would attempt to reduce the benefits and increase the costs of the deciding equation.

As far as the reduction of benefits is concerned, there are clearly two possible policies. One would involve reducing the applicable tax rates; the other, in reducing the taxpayers' compliance costs.

Probably the PBD may constitute the key variable of the basic model and its influence may likewise be extended to other behavior models. Therefore, a greater part of managerial actions and measures of the T.A. should be aimed at reinforcing this variable. I understand that the advantage of asymmetrical information for the T.A. should not be disregarded, neither for the administration

or society as a whole, since it allows for increasing the levels of compliance without cost. It should rather be strengthened by means of "exemplifying" examinations of well known individuals.

Apart from this, it would seem clear that reinforcement of the PBD calls for developing the necessary capacity for massive handling of information. First of all, the information included in the tax returns and in this respect, we should not forget that a well designed tax system may provide powerful control mechanisms. Likewise, one may and should resort to the systematic use of relevant external information.

Second, the convenience of undertaking massive verifications of professionals, farmers, and small businessmen, above all, render it advisable to use "results models" whereby one may estimate, by types of activity, the average values -and the respective margins of trust - for the tax variables of interest (sales, benefits, etc.) based on other variables that may be easily determined. This type of models is also used as criterion for deciding the taxpayers who will be subject to individualized examination.

There is no doubt that auditing, individualized examination, constitutes a powerful instrument for detecting fraud and, at the same time, for obtaining relevant information, such as, for example, the taxpayer's behavior before the tax or economic and accounting information that may help us improve the "results models". In any case, auditing is an instrument that must be carefully used since, depending on the way it is used, it may give way to contrary reactions on the part of the taxpayers. Leaving aside the cases of corruption, there is a temptation that is common to auditors and that is, to prefer discussing legal qualifications rather than contributing information about hidden bases. This bias, taken to an extreme, may give the taxpayer who has declared well, the sensation of not being properly treated and encourage him to commit fraud.[14] In sum, if examiners must always obtain additional collection, it will be preferable to defraud amply, leaving some simple trails so that they may find a (small) part of what they are looking for and may leave happily.

Sanctions are the last variable considered. Contrary to what the basic model suggests, there seems to be in every society criteria as to what we could call reasonable or proportional sanctions. This would be something to be

[14] On this issue, see the work by K.A. Kinsey, “Deterrence and Alienation Effects on IRS Enforcement: An Analysis of Survey Data” included in the book edited by J. Slemrod, “Why People Pay Taxes,” The University of Michigan Press, 1992.

verified in each case and if it would turn out to be true, it would call for adjusting the decision-making equation which operates on the PBD which unfortunately is a more complex and costly instrument.

Likewise, the structure of sanctions is important. There are systems where only those who incur in fraud are subject to review of previous periods. Normally there are aggravated sanctions in cases of relapse and in some countries, even imprisonment in extreme cases. All this calls for an analysis on their effectiveness, the effectiveness of the sanctions policy for deciding their design.

As we have indicated, this model of behavior which in its simplest expression would correspond to a rational as well as amoral person, contrasts with the behavior of those citizens who comply with their tax obligations apparently due to reasons unrelated to said economic calculation which is contemplated by the basic model. Certainly in this type of taxpayers there are other variables that determine their behavior and which should be identified. However, one cannot neither disregard that even in this case, the variables of the basic model may have some influence.

As shown, by the recent experience of the IRS, based on reforms initiated in 1998 which were focused, as it is known, on voluntary compliance and disregarded the most coercive (enforcement) control actions, there was a drawback in the levels of compliance thus showing the influence of control even among those taxpayers that duly comply with their tax obligations, apparently for other reasons.

Now then, without rejecting the influence of the variables of the basic model, it must be admitted that there are groups of taxpayers where there are other variables with great influence in their tax behaviors, thus giving way to other types of response.

3.2. The Citizen Model.

Among the taxpayers that abide by these behavioral guidelines, there is initially an acceptance of the tax for reasons we should investigate. It appears to be frequent that in these cases there are variables that are not strictly economic and which are the determinants of the behavior observed. For example, a strong sense of belonging and commitment toward the social and political values of the group facilitate a high fiscal morale. Something of this sort appears

to have happened in Spain in the past years, since the recovery of democracy, which would contribute to explain that it has been possible to practically double the tax pressure without evidencing rejections.[15]

Undoubtedly values and personal ethics play a decisive role in these behaviors;[16] role which will be reinforced to the extent that taxes claimed are deemed justified and are demanded under terms equivalent to those of the other members of the group.

Nevertheless, the convenience of achieving said status of opinion is rendered difficult by the asymmetries that generally characterize the opinions of taxpayers when questioned about these issues. Without denying the elements of truth that may exist in many cases, what is really true is that citizens generally think that taxes are never equitably distributed and, of course, that whoever has more does not pay more taxes, while at the same time they have a perception of their own behavior that is far removed from reality, which provides them a certain moral coverage for evasion.[17] It is clear, then, that in spite of difficulties, pedagogy and informative transparency may contribute to compensate such biases, favoring acceptance of the tax and their voluntary compliance.

Along this same line, a very important variable which we have not considered up till now is public expenditure, that is, the goods and services provided by the state in exchange for taxes. In our opinion, to explain taxpayer responses to the tax, the effectiveness in administering the resources obtained by the treasury is very important. It is very difficult to accept a tax when the resources thus obtained are devoted to purposes that seem to be inappropriate or, what is even worst, if they are squandered. Therefore, to defend taxes it is important to seriously take care of public expenditure.

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15 On this topic you may see the work by J. Martinez-Vazquez and B. Torgler, "The Evolution of Tax Moral in Modern Spain," to be published shortly.
Likewise, the work by J. Prieto Rodriguez, M.J. Sanzo Perez and J. Suarez Pandiello, "Economic analysis of the attitude toward fraud in Spain," Working Paper, University of Oviedo, 2005.

16 On this issue, see the work by M. Wenzel, "Motivation or Rationalization? Causal Relations between Ethics, Norms and Tax Compliance" to be published shortly in the Journal of Economic Psychology.

17 The biases and inconsistencies of opinions of the taxpayers on these issues may be verified, for example, in the series of surveys carried out by the IEF (Spain) with the support of the AEAT that are published in the compilation of Documents that belong to IEF. The last one published which corresponds to 2004 is the Document number 11/05. One may also see the article "Does Deterrence Deter? Measuring the Effect of Deterrence on Tax Compliance in Field Studies and Experimental Studies" by D.J. Helling, H. Elffers, H.S.J. Robben and P. Webley in the book "Why People Pay Taxes," op. cit.

If one manages to ensure that taxpayers pay their taxes, the normal thing would be for them to demand from government an adequate use of resources and that is precisely what should be guaranteed and explained since, otherwise, the levels of voluntary compliance will most probably decrease. As it may be seen, it is a path that does not allow intermediate stops: it is impossible to pay well and spend poorly. The use made of taxes is so important that in order to achieve greater acceptance of taxes some countries resort to allocating certain taxes to specific expenditures. For example, estate taxes are used to finance equal opportunities policies, thus ensuring the collaboration of the taxpayers.

Several authors have analyzed the importance of regulations and social behaviors in the decisions of taxpayers. Worth noting in this area, for example, is the importance of the behavior of the other members of the group. There is an "imitation effect" that reinforces the sense of belonging.[18] This characteristic of taxpayer behavior, if it turns out to be significant, as it appears, would make of evasion a, let us say, contagious behavior in any direction, and, therefore an exponential behavior within a specific critical mass which, according to the direction taken, could extraordinarily facilitate or render difficult the T.A.'s task.

3.3. Strategic Behaviors.

Going back to the basic model, until now we have implicitly assumed that the T.A. would decide its parameters, fundamentally, the PBD and the sanctions. Likewise, the taxpayers, in the light of said parameters and their willingness to assume risks, would decide their behaviors. Nevertheless, there is a family of models that imply strategic behaviors for the taxpayers as well as the administration. In this case, the T.A. may decide the PBD, bearing in mind the taxpayer profiles and behavior, while the latter structure their behavior by taking into account the administration's reactions.

Although, in principle, this type of models would be of general application, because of their characteristics they would seem more typical of large taxpayers, fundamentally large businesses that design their own tax strategies to minimize the taxes to be paid, by resorting to economies of option, as well as to the legal gaps or inaccuracies that could exist, frequently bordering on the limits of legal fraud. As it is obvious, these behavior guidelines calls for in-depth knowledge of the regulations and resorting to specialized legal counseling.

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[18] See the work by B. Fortín, G. Lacroix and M. Villeval, "Tax Evasion and Social Interactions," Discussion Paper, 1359. The Institute for the Study of Labor (IZA), 2004, which highlights the influence of values and behaviors of the group being discussed.

In the basic model we considered that the PBD was a parameter to be decided by the administration. Reality is something more complex since, one thing is to audit a taxpayer; another that the auditor manages to discover all hidden contributions and still another that the justice courts fully agree with the auditor. Thus, without going any further, the PBD may be seen as the product of three different probabilities. The first is the one that is more in the hands of the administration, although not completely. Thus, for example, if the T.A. establishes an examination criterion of the cut-off type, deciding to fundamentally audit taxpayers whose declared income does not reach certain levels and this criterion is known, obviously the probability of being audited will depend on the level of declared income which is the taxpayer's decision. The greater the income declared, the lesser the probability of being subjected to audit.

It may also be that the T.A. does not explain the criteria to be used in selecting taxpayers to be examined, in which case the nucleus of the game would be focused on the other two probabilities which, if we observe, we may see that they are not exclusively dependent either on the T.A., but rather, to a great extent, on the strategy adopted by the taxpayer.[19] With good legal counseling the risks of being discovered may be minimized and, above all, of losing before the courts which, ultimately, would be the most important probability.

It is clear that, in view of this type of behaviors, the policies to be developed by the T.A. must be different from the ones previously considered. There is no doubt that here the administration could also behave strategically, but in any case it would be convenient that its means would be similar to those which large taxpayers generally have available. Otherwise, the game would not be balanced.

Given that large multinational businesses are involved, the support and cooperation of other T.A.s would be decisive, especially from the T.A. where the parent company has its headquarters. Bilateral as well as multilateral conventions and agreements may be very useful in considering these cases. Likewise, it would be advisable to develop normative policies that may fill the gaps and correct possible legal inconsistencies and/or contradictions that may give way to this type of behaviors. Undoubtedly this purpose may result in a permanent task because, while closing a slit in the fiscal law we may probably be opening another elsewhere.

[19] Obviously, it may also depend on the possibilities of corrupting the examiners, as appropriate. On this matter, one may consider, for example, the work by A. Vasin, “Models of Tax Enforcement with corrupt tax inspectors” presented at the First World Congress of the Society of Games Theory, held in Bilbao (Spain) in 2000.

Some issues of special relevance are worth synthesizing from the review of the taxpayer behavior models we have just considered. First of all, there clearly seem to be two variables - the PBD and the sanctions - that play a very important role. They are a core issue in the case of the basic model and of the strategic behavior models, but also important in what we have called the citizen model. In empirical comparisons, withholding systems and obligations to provide information appear as fundamental elements of the PBD.

Secondly, all taxpayer behaviors are not the same, and therefore it makes sense to separate them and propose differentiated policies.

Third, there are taxpayer groups where the economic variables do not fully explain their behavior, regardless of the influence they may preserve. Personal ethics and the behavior of the group, of the others, appear here as important variables to be considered.

Finally, and I would like to emphasize this aspect, a variable influencing the behavior of taxpayers is the state's own behavior. If the state's behavior is perceived by taxpayers as unfair and/or ineffective, there will undoubtedly be great difficulties for collecting taxes. That is why it is so important that the tax system be considered equitable and that expenditures be addressed to effectively responding to social priorities. Again there appears the state's behavior, in this case, specifically in tax examinations where, extremely formalist postures on the part of the auditors may become a factor that may contribute to fraud rather than avoid it.

Therefore, it is convenient to recall that evasion not only depends on unrelated variables but also, and I would say to a significant extent, on the state's own decisions and behaviors and this is something that should not be forgotten.

First, to attempt to act correctly and, if this is not so, to be aware of the limits this sets for the T.A.'s actions.

4. EVALUATION OF THE POLICIES

We have just examined the characteristics of the three types of taxpayer behavior models that have aroused greater attention in the past years and which may guide us with respect to the relevant variables in the different taxpayer segments. Nevertheless, this is a task where one's own work, that of each T.A., on analyzing and verifying the behavior hypotheses formulated by using each country's data, is indispensable. That is precisely why it is so important to regularly develop fraud maps that may allow us to set objectives, guide policies and value their impact.

Let us imagine that, on developing a fraud map we may reach the conclusion that the greater part of evasion, for example, takes places among professionals and small and medium enterprises, which segment within the margin of fraud is located, let's say, at 50%. With this information one could set the objective of reducing the margin of fraud for this group of taxpayers, for example, by ten percentage points within a specific time frame.

In attempting to achieve this objective, the first step would be to identify variables mainly influencing decisions with respect to the tax in this group of taxpayers, for which purpose several models of behavior must be tested and verified. Having done this, let us imagine that we have concluded that in this taxpayer segment economic variables are the most important ones and, among them, the outstanding one with respect to the level of compliance is the PBD. We may probably have reached this conclusion after functionally relating several variables to the fraud margin, with the relationship to the PBD being the most significant one and that will allow us at the same time, to quantify such influence. This means that if our objective is to locate the fraud margin at 40%, the previous functional relationship will approximate the value that should be reached by the PBD in this case, for achieving said objective. As of this moment, we could say it thus, we would have available an intermediate or instrumental objective -whose achievement would be, normally, a responsibility of the T.A. - consisting of the value that could be reached through different means. Thus, for example, one could introduce a system of withholdings or on account payments; one could establish additional information obligations; reinforce the audits; initiate an investigation campaign to detect individuals from the segments who have not declared. Obviously, there are many alternative actions or policies to attempt to achieve the proposed objective and the issue is to select those that are most effective, bearing in mind the resources which the T.A. may have available.

To select the most adequate anti-fraud policies in each case, we would need to determine first, the impact of each policy on the objectives. In a first approximation we could limit ourselves to examine the impact of each policy on its objective to then further on examine the possible crosscheck effects. Secondly, we would also need to know the costs we would have to incur to implement each of the policies designed. Counting on this double information, it would be possible to calculate for each policy, an indicator of its impact by unit of cost that could be considered an indicator of its effectiveness.

4.1. The Impact on the Objectives.

It must be admitted that it will not be simple to estimate the impact of the policies, but it is no less true that there are several ways of approximating this issue and that having available some quantitative and comparative information is always preferable to having nothing. In this field, it would be convenient to consider possibilities and move gradually, it being understood that we are faced with a task that should be permanent in any T.A.

By having available the quantitative information provided by the regularly developed fraud map, we could try to measure the impact of the policies, using econometric models; that is, estimating functions that may relate policies as independent variables, to the levels of fraud in the different t segments of differentiated taxpayers.

In order to eliminate the influence of a specific policy, it would also be important to resort to the use of a sample group, to which the policy at issue would be applied, comparing the results with those shown by the rest of the taxpayers to whom said policy was not applied. The mathematical modeling has the advantage of directly providing quantitative results and allowing multiple variants with varying levels of complexity.

4.2. The Cost of the Policies.

The other task to be performed, as we have indicated, involves the estimation of the costs of different policies. Curiously and even though the T.A. may be seen as a service-producing organization, analytical accounting for determining the cost of the different services rendered or the cost of managing the different policies is not frequently used. Therefore, we should move in that direction and should do so by attempting to determine not only the costs incurred by the T.A., which are the management costs, but also by identifying and quantifying the costs of compliance that must be incurred by the taxpayers for fulfilling their tax obligations, since the sum of both is actually the relevant amount.

In fact, if we want to adequately measure the costs of the different policies to evaluate their effectiveness, we should take into account the management costs as well as compliance costs since, in many cases, they are interchangeable costs and if this is not done, we may be introducing a bias in favor of those policies that involve lower management costs at the expense of increasing the compliance costs. There are also cases where the opposite could occur.

4.3. Indicators of Effectiveness.

As we have indicated, if we would have available a measure of the impact of each policy on its objective and parallel to this, of their implementation costs, we could assign them an indicator of effectiveness as a result of combining both variables. Such indicator would show, for each policy, the cost of achieving a specific proportion of the objective. Let us imagine that the objective is to reduce the tax gap. Now then, the effectiveness indicator of a policy could tell us how much it costs to reduce by one point, for example, the fraud gap or alternatively, by how much can the fraud gap be reduced for every, let's say, ten thousand dollars of T.A. expenditure. By having this information available it will be simple to classify the policies and select the ones that are most effective.

5. MANAGEMENT AND POLICY: DISTRIBUTION OF RESPONSIBILITIES

As we may see, the starting point for all the sequence we have been describing and which should lead us to select the most effective policies is developing a fraud radiography based on estimations of potential collection. It will allow for electing consistent objectives for the tax administration, structuring and verifying different hypotheses of taxpayer behavior vis-à-vis the tax, designing the most adequate policies and classifying them according to their effectiveness and with all that, arrive at specific commitments of the tax administration, as professional organization, with the political sphere. We are, thus, faced with a process with three successive and differentiated stages:

- election of the objectives of the organization,
- selection of the most adequate policies for achieving the objectives determined, and
- implementation of the policies.

whose responsibility will be distributed between the political and administrative spheres, depending, in each case, on the configuration of relationships between both spheres.

In general, it is accepted that in any case, determination of the objectives corresponds to the political sphere and implementation of the policies is a responsibility of the administration. Instead, the intermediate stage may correspond to the political sphere, to the administration or a combination of both, depending, as we said, of the model of relationship existing in each case between policy and administration. In a traditional administration

headed by politicians it is difficult to distinguish between the political and administrative sphere and much less between their respective responsibilities. In such case, it will be difficult to expressly establish quantitative objectives of the type indicated and above all, that the T.A. accept commitments and, as appropriate, the corresponding responsibilities be demanded.

Actually, in order for the T.A. to commit itself to a series of quantitative objectives it is necessary that there be certain margins of decision-making autonomy with respect to the political sphere, margins that may afford it sufficient decision-making capacity in order to comply with said objectives. Now then, depending on the level of autonomy of the tax administration, the latter may carry out the second stage or the decision may be made at the political sphere, although in this case, normally counting on the counseling and proposal of the administration which should assume responsibility for the design, configuration and evaluation of the policies.

6. CONCLUSIONS

I would like to conclude my presentation by highlighting the main elements of the argument. In the first place and due to the reasons explained, the margins of fraud constitute the variable that should be used as reference for structuring the T.A.'s objectives. It is not total collection or much less that directly collected as a result of the control actions of the T.A. Secondly, to measure the margins of fraud we must estimate potential collection and from there follows the interest in this amount and its calculation that allows us to have a fraud radiography, without which the policies of any administration would proceed heedlessly. Third, fraud radiography is the instrument that will allow us to count on:

a) the necessary information for analyzing the different taxpayer behavior models vis-à-vis the tax whose study, as we know, will allow us to derive the corresponding policies, and

b) the information that will allow us to estimate the impact of each policy on its objective.

Fourth, to evaluate the policies implemented by the T.A., we must know, in addition to their impact on the objectives, their costs, that is, the managerial as well as compliance costs borne by the taxpayers. Finally and as recommendation, I deem it of interest that the T.A.s may regularly take care of the issues discussed, by obtaining the means necessary for such purpose, regardless of the fact that means of collaboration on this matter may be established with other T.A.s

TOPIC 1

DETERMINATION AND ESTIMATION OF THE POTENTIAL COLLECTION. ANALYSIS OF THE ECONOMIC-TAX POTENTIAL AND ITS CONDITIONING FACTORS

Lecture

TOPIC 1

DEFINING AND ESTIMATING POTENTIAL COLLECTION. ANALYSIS OF THE ECONOMIC-TAX POTENTIAL AND LIMITATIONS THERETO

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1. INTRODUCTION

Currently, most countries employ taxation as the main source of Government funding. Nevertheless, international data show a significant gap between tax burden values (effective collection divided by Gross Domestic Product) in developed countries versus developing countries. Developed countries have traditionally reported tax burden values above those collected by developing countries. Therefore, we shall look into the grounds for this difference. Should the difference be attributed to the decision of a more

collectivistic society (greater presence of the State in economic affairs) in wealthier countries or to structural factors bearing an influence on the tax burden? An interesting question would be: in the case of a poor country, would it adopt the same tax legislation in order to have a State with the same proportional size in the economy as the latter and would the resulting tax burden be the same?

In fact, it seems that despite the fact that the size of the State in the economy varies according to a collective decision (the spending level pursued and the tax legislation applicable to fund it), the State itself depends on the economic, social and institutional conditions to collect taxes in the given country. In other words, the effective tax burden of a country is influenced by the collective decision as to the amount payable (based on the decision of the size of the State and the resulting tax legislation adopted) as well as the structural conditions in the country. This leads to another question: would a tax potential, understood as maximum tax capacity, apply for any country? If so, which would be the limitations thereto? Which would be the forms to implement it for effective collection to come close to Potential Collection? Is the degree of tax effort to meet this potential the same for wealthy versus poor countries?

This paper seeks to analyze these issues pertaining to the economic field, but it specifically intends to apply them to the area of tax administrations. This is why the ultimate objective of this study is the use of the concept of tax potential as the parameter to measure the efficacy of the tax administration. We shall see that, once the tax potential has been defined, the gap between this potential level and effective collection is explained by tax evasion. The performance of the tax administration as the agency that oversees full compliance with legislation and tax law in the enforcement of the regulatory structure shall pursue evasion reduction. To that end, the tax administrations needs to manage their risks and become strategically positioned to make the best use of their limited resources in the efforts to counter evasion, or in the attainment of the tax potential.

The text has been structured as follows: Section 2 shall delve on the conceptual issue of tax potential and includes international data on this variable. Specifically, the structural and legal notions on tax potential shall be presented. Section 3 analyses the reason why the concept of legal potential is to be effectively employed as a long-term goal and the performance indicator of a tax administration. We shall see that addressing Potential Collection is only an estimation of tax evasion, attempting to understand the inherent risks imposed by evasion on tax administrations. Finally, Section

4 shall analyze what type of tax administration, in terms of strategic positioning, better accommodates working with tax potential as an effective goal to be attained. The conclusions are presented in Section 5.

2. TAX POTENTIAL

Definition and limitations

Firstly, we shall highlight that the definition of tax potential herein is not the only one possible or in use. This concept has been addressed in a number of academic papers and linked to issues such as tax burden, tax effort and tax gap, among others. The idea is to define it herein so that it may apply to the analysis of tax administrators. Therefore, this paper shall classify tax potential according to two trends: structural and legal.

Structural tax potential is the expected collection by a government from the private sector, by enforcement of an optimized tax system, considering the economic and social conditions in place in a country. That is to say, considering the degree of development (structural features) of a country, it would refer to the collection that would be naturally obtained. As we shall clarify further on, the idea pursued herein is that of expected collection based on normal capacity or effort of the economy.

Obviously, there is no way to measure said tax potential in objective terms because it is a theoretical notion. Nevertheless, in practice, it may be assessed based on the limitations thereof, that is to say, based on variables that are effectively measurable and strongly correlated with tax potential. Available literature (Piancastelli, Varsano et al, Stotsky and WoldeMariam, Davoodi and Grigorian) indicate the following variables as limitations to a country's tax potential:[1]

- National Per Capita Income (positively related), since the greater the available income is, the greater are the tax base and the economic capacity to be considered;

1 It is worth mentioning that there are a number of econometric studies on the topic and that the variables mentioned not always feature the same performance. For example, there are studies stating that the share of the agricultural sector in the GDP is significant and negatively affects potential. In others, this variable does not feature a strong correlation. In this paper, we have presented the variables that are mostly cited in literature as limitations to tax potential, regardless of the fact that some of them, in certain studies, may appear with an immaterial impact on tax potential.

- Participation of the agricultural sector in the GDP (negatively related) since this sector is usually taxed at lower rates (essential assets), in addition to the inherent difficulties for control by the tax administration (small businesses or cooperatives, distant from urban centers, poor accounting practices, etc).

- The portion of the urban population in the overall population (positively related), expressing a more organized, formal, literate, monetized society with large corporations, greater tax awareness by citizens, better control by the tax administration and potential implementation of instruments such as source withholdings;

- Degree of openness in the economy – that is to say, more imports divided by the GDP- (positively related), which entails a relevant tax base to be exploited and easier control (customs);

- Share of mining and natural resources sectors in the GDP (positively related), since, contrary to agriculture, the economic sectors linked to mining and oil industries, for example, generate a high potential tax base that is easier to control (few large corporations to oversee).

Also, the above-mentioned factors, among others, enable to estimate a country's structural tax potential, since they may be considered as the main critical factors that, if properly combined and exploited by an optimized tax system, would lead to maximum collection levels. It must be understood that these limitations have been pointed out by empirical studies as the best explanation of a country's tax burden, although, in specific cases, one of those factors may be irrelevant or that there may be other more relevant ones.

What this paper seeks to explain, which is of relevance for tax administrations, is that the volume and makeup of the economic base may set hurdles to the realization of revenue. For example, let us imagine two countries A and B, both with a 100 u.m. of GDP. Nevertheless, the GDP from country A stems fully from agriculture, while the GDP of country B is fully generated by the Industrial Sector. As an outcome of this scenario, the population of country A is rural, with a low degree of formal business transactions (let us even imagine informal trade practices) and family labor. On the other hand, the population from country B is urban, salary-earning, with payments made through the banking system. Despite having the same tax base (let us assume the same rate for both sectors), it is very likely that the collection of country B shall be greater than that of country

A. The tax administration of country A, in addition to the difficulties in reaching the area and accounting records, shall lack the resources such as source withholdings or third party information to ensure direct collection, and shall also lack the tools to analyze or estimate a value for trade transactions. In practice, in addition to all these difficulties, the agricultural sector is taxed at low rates, mostly not to impose taxes on the price of food and essential assets for citizens. Therefore, it is understandable that countries with a large share of GDP held by the agricultural sector have a more limited structural potential. The same type of analysis applies for other limitations, to explain the logic of those factors in the grounds for revenue collection.

Considering the aforementioned factors, it seems reasonable that developed countries enjoy a truly greater tax potential than developing countries. The fact of having a higher per capita income, greater percentage of their population living in urban areas, more formal and industrialized economic organization, and high degree of openness to foreign trade, makes the wealthy countries enjoy a tax potential to tap, that generally does not exist in poor countries. Therefore, the economic base and their makeup affect the tax potential of a country. Notwithstanding, structural limitations exist that may prevent certain countries from increasing their revenue collections and pursuing a fiscal status that is sustainable in the long term. Moreover, should the country finally require to adopt a tax legislation that demands more collection than the structural potential, a great tax effort will be required to achieve it.

The second approach is aimed at a more objective purpose for the tax administration, precisely because there are limiting factors in the structural potential that are beyond the scope of action of revenue agencies. A more accurate definition is pursued for tax administrations to employ as a goal. The legal tax potential is defined as the maximum collection that may be obtained by the effective application of a given tax system. In this case, the tax system is defined, determined and provided for by the country's legislation, which may or may not exploit the full structural potential in place or still pursue income above this natural potential. The legal potential is only achieved if the enforcing tax administration is 100% effective. This concept is close to the definition by Das-Gupta and Mookherjee,[2] "potential collection is that which would be collected if no taxpayer would voluntarily breach the law and involuntary errors would amount to zero."

2 Das-Gupta and Mookherjee (1998), Incentives and Institutional Reform in Tax Enforcement, Conceptual Approaches to Tax Policy in Developing Countries, p. 29.

This second concept better suits the reality of the tax administration since it may even be used as a performance indicator thereof. And the tax administrator may effectively set forth this potential as the goal of his organization. This concept enables us to refer to the core issue of the 40th CIAT General Assembly "Potential Collection as the Goal of the Tax Administration", to the extent in which "the management of a tax administration could be understood, according to this second parameter, as more or less effective if the collection achieved is close to the Potential Collection."

This is in line with the inherent mission in the tax administration, which ultimately seeks that taxpayers meet their tax obligations in full. According to Bagchi et al,[3] "the raison d'être for any tax administration is to ensure compliance with legislation. In the ideal law-abiding society, people would pay their tax liabilities and the tax administration would only devote its efforts to making available the facilities for them to meet their obligations." In practice, evasion and inefficacy of the tax administrations are the main reasons by which the effective tax burden does not match the legal tax potential.

The more effective the tax administration in reducing evasion, the smaller the tax gap, that is to say, the difference between effective collection and Potential Collection (legal), and the tax administration shall be closer to the goal as an institution that meets its mission.

Figure 1 sets the example about the relation among the aforementioned concepts. There are two possible situations. In situation A, a country brings said structural potential to a standstill (based on the economic capacity thereof) but its tax legislation is such that, although fully and effectively enforced, generates a legal potential that fails to meet the structural one. When, the structural potential of a country comes to a standstill, there is a potential that is unexploited by the legislation in force, which we shall define as the potential gap. This potential gap is a space in the country's economy to still apply a relatively low rate for the tax effort. In other words, a country with a large potential gap knows that, in fiscal straits, there will be space and response from the economy should its tax system be modified with a view to increase revenue collection. This is indeed a potential to be explored. The legislation in force defines the limited potential, which is the portion that should be tapped by the effective enforcement of the tax legislation in place. Nevertheless, reality indicates that there is no country

3 Bagchi et al (1995) An Economic Approach to Tax Administration Reform, Discussion Paper n. 3, International Centre for Tax Studies, University of Toronto, p. 8.

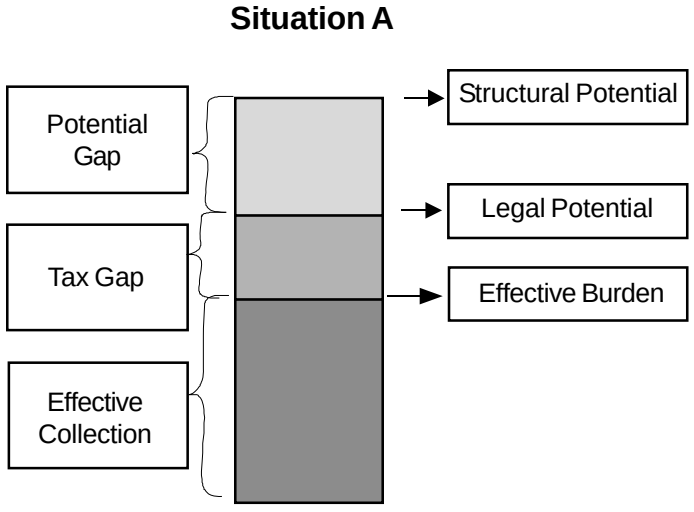
in which effective legislation is fully enforced. Therefore, the effective burden is, in general terms, lower than the restricted potential, and the difference between those two variables is defined as tax gap.

In situation B, the tax legislation of a country determined a legal potential degree that is above the structural potential. In this case, we shall call the difference between these two potentials a potential surplus, pointing out that the economy is undertaking an effort that exceeds the natural effort in terms of tax revenue generation. It is the reverse concept of potential gap. The definition of tax gap remains the same: the difference between legal potential and tax burden.

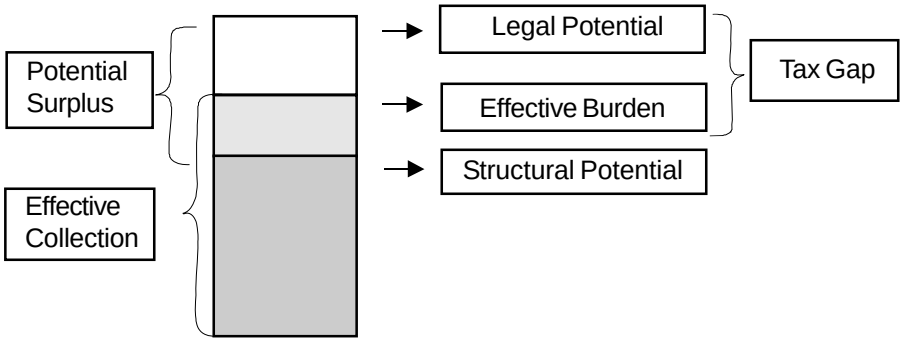
In both cases, the ratio in percentage between effective burden and the structural potential is called tax effort, and it renders the degree of use by a country of its natural tax capacity. That is to say, even if two countries feature an identical tax burden, it may occur that one is making a great effort to achieve this performance (positive effort – situation B), while the other may be generating this collection in comfortable terms (negative effort – situation A).

Figure 1

Example of the Broad and Limited Potential Concepts



Situation B



The theoretical structure defined herein is of utmost relevance for the purpose of tax policy and administration. The relevance of analyzing and estimating the tax potential of a country is worth highlighting. If we consider that the number itself shall be always an estimation, it is important to know its order of magnitude and, moreover, the notion whether the country operates with a gap or a potential surplus. This based on the fact that if a country deems there is a potential to be tapped, it may make relevant tax policy decisions like changing tax rates on the basis of maintaining the current administrative capacity and shall achieve an effective collection increase. On the other hand, in the case of a country that has exceeded its potential, should a fiscal adjustment be required, it shall decide on cutting down on expenses, since it knows that very likely, tax increases shall not result in the practical effects expected, given their economic restriction.

For the tax administration, it shall certainly become a more difficult task to enforce legislation in the cases in which the tax effort required is very significant. This is due to the fact that in a country operating in the framework of a strong social effort to meet tax payments this situation may entail an increase in non-compliance or evasion, or even, according to Varsano et al (p. 25), it may end up in “a strong effort in the long-term that generates tension and ultimately, taxpayers’ “reluctance.” Moreover: “In fact, strong and long-term effort is only attainable with good quality tax systems and fair distribution of the tax burden and even so, with practices that are well accepted by society.” We must underscore at this point which taxes, in practice, create distortions and may affect the good economic performance in the long term, mostly when imposing a great effort on the economy. The caveat in this assumption is the old story of not “killing the goose that lays the golden eggs.”

It is worth highlighting that the notion of structural potential presented herein refers to a macro vision. It seems interesting to work with this concept on a micro spectrum, for example, trying to understand whether there are structural potentials for every basis of incidence that a country exploits. In practice, tax systems divide the economic base into types of tax incidence. The most widely known are income, consumption and equity. It may be the case that each one of these bases entails a different tax potential level and therefore, more specific limitations to each base. Should that be the case, it may also occur that, in situations in which a country is operating with a potential gap in total terms, some of the bases may be over-taxed (operating with a potential surplus) while others are quite below the structural potential. Situations like this may lead to the idea of fiscal unfairness and low collection efficiency. From a given level, depending on the type of market or asset taxed, it may occur that very high rates end up stimulating evasion or flight from economic players to other tax jurisdictions or other sectors with lower tax rates. Therefore, a country with surpluses in other tax bases, may try to strike a balance in the efforts undertaken, adjusting it to the sensitivities in each market.

In summary, a country's tax legislation is, in practical terms, the consequence of the size of the State desired by society, or which society may require owing to reasons of fiscal adjustment. Legislation may define a legal potential that is above or below the capacity that would be deemed the natural tax-paying capacity within an economy. Should it be below, this indicates that there is still room to collect taxes without implying an excessive economic effort, and probably, a tax administration performing in these conditions shall pursue its mission effectively without major difficulties. Should it be above, it is relevant for government to be aware of the fact that it is demanding a greater effort from its economic players, and this situation per se may be extended only if it implies a genuine social decision to a greater participation of the State in the economy, and especially, with a fair tax system, with low economic distortion and low administrative costs (in other words, good general practices). Otherwise, it shall be difficult to avoid that the tax gap (evasion) increases in time, ending up with the generation of known situations of ongoing nominal tax increases, but a deficient effective collection, indicating a concomitant increase of evasion.

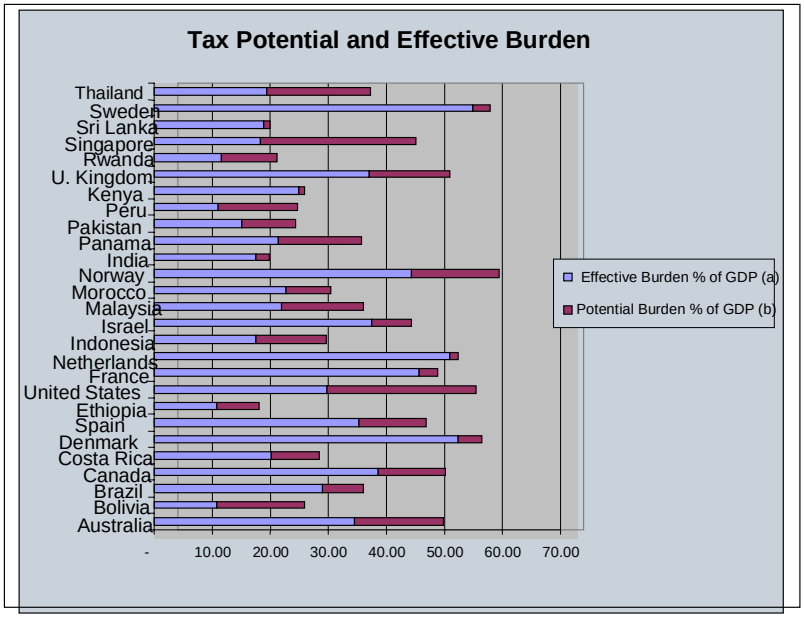
Knowing how to handle these concepts, and understanding which is the situation that applies to your country is, therefore, the fundamental analysis for tax policy-makers and the tax administrator.

International empirical data

The concepts presented herein render a theoretical analysis tool. In practice, certain studies that employ econometric or statistical methods seek to capture the tax potential of countries and their respective tax effort. They do not employ a methodology that accurately calculates the above-defined concepts, but pursue, in an intermediate fashion, to estimate a country's tax potential. We present two studies with empirical results on the matter: Varsano et al (1998) and Piancastelli (2001).

Varsano's paper sought to estimate the tax capacity of a country defined as "the maximum tax income attainable in a society," by the analogous analysis on the production limits in the economy. It is said of an economy that it operates in the limits of production if there is no other possible combination with the existing resources that enables an increased production level. Therefore, we may state that a country operates at its tax potential if there is no possible combination, given the existing resources to produce greater revenue. Chart 1 features the estimations calculated for 27 developed and developing countries for 1991. The variables employed to estimate tax potential were: overall population, GDP per capita, inflation, inflation fluctuation, industrial GDP share in overall GDP, share of the economically active population as to overall population, share of urban population as to overall population and income distribution.

Chart 1



Source: Varsano et al (1998)

The aforementioned data indicate interesting and illustrative situations of the issues and concepts under discussion. Firstly, in line with our definition of structural potential and its limitations, the more developed countries feature a greater potential than developing countries. It is expectable that wealthier countries have a broad potential to exploit, given their more favorable structural limitations. We may observe from the samples considered, that only Norway, Sweden, Denmark, United States, Netherlands, United Kingdom and Canada enjoy a potential above 50% of GDP. On the other hand, Rwanda, Ethiopia, India, Sri Lanka, Pakistan and Peru feature a lower potential (under 50% of this value), that is to say a maximum of 25% of GDP.

Secondly, the fact of enjoying a great potential to be tapped does not necessarily entail a high tax burden in a country. It is possible that there be countries that do not wish to exploit their full broad tax potential based on a number of reasons: a) the country does not wish to have a welfare state-type society, that is to say, they do not desire that the size of the State be substantial in their economy and prefer that certain assets be provided by the private sector; b) the country understands that, in spite of the potential available, taxation in practice always introduces economic distortions that may reduce long-term economic growth and prefers to maintain the effective collection level in certain values below the potential;[4] and c) the country enjoys a comfortable tax status and prefers to leave the existing potential for situations of fiscal crisis.

Whether owing to the above-mentioned reasons or otherwise, it is interesting to note the behavior of the United States and Singapore against countries like Netherlands, Denmark and Sweden. In spite of the fact that all those countries enjoy a high potential, the option of the United States and Singapore is to not exploit it significantly. According to this study, Singapore exploits 40.52% of its potential. This outcome, in the case of the above-listed countries does not reflect the administrative or institutional inability to meet the potential, but a voluntary decision not to do so. And that is the reason why that measure of the potential is insufficient as a tax administration performance indicator, but moreover as a tax policy development guideline.

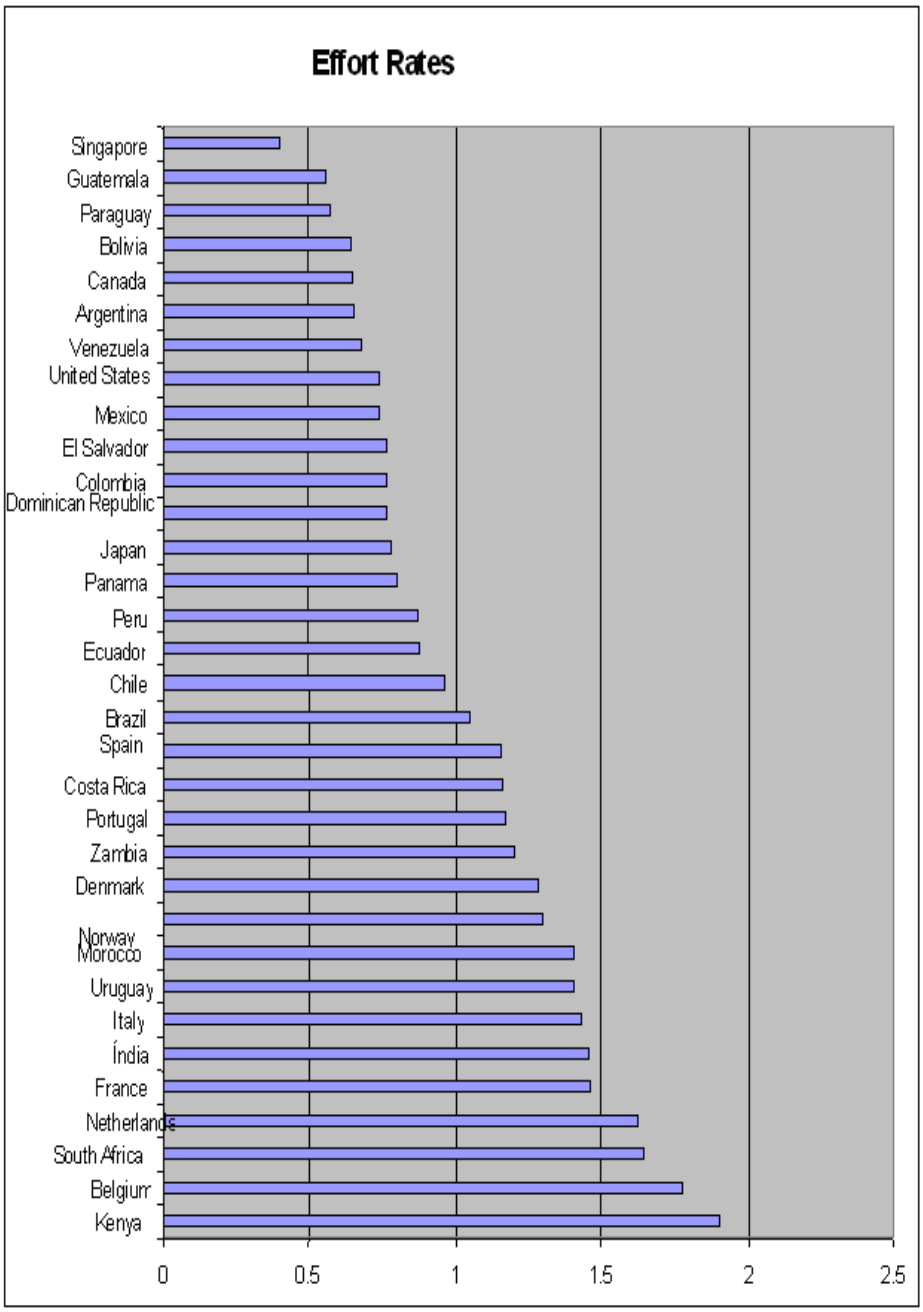
[4] In other words, the fact that a country enjoys such a high tax potential does not imply that, if fully tapped, they would be optimizing the economy overall. As we know, any tax, in practice, introduces distortions in the economy based on the so-called “deadweight loss”. Thus, the potential indicates room for taxation given certain structural features in the economy, but certain countries may deliberately not wish to use it since they are aware that more taxes almost always imply greater economic distortions and, possibly, lower growth rate in the long-term. (I wish to thank Mr. Jefferson Rodrigues for this analysis).

Thirdly, certain developing countries, in spite of having a potential that is not so high, may seek to offset this natural economic restriction with a great tax effort, so as to attain a more satisfactory level of tax burden. Brazil, Kenya, India and Sri Lanka are examples of developing countries with a tax effort above 80%. Thus, Brazil, for example, featured an effective tax burden in 2004 of 36.91% of GDP (the sample information refers to 1996), above other developed countries, in spite of a lower tax potential than some of them. On the other hand, there are developing countries that feature a low tax effort, and that, in line with a lower potential, defined relatively low levels of tax burden. Therefore, the simple comparison among tax burdens from poor and wealthy countries sometimes fails to express the degree of effort in a society to meet said result. Nevertheless, what should be clearly understood is that although Singapore and Sri Lanka feature a similar effective burden, the effort by the population of Sri Lanka to meet this burden is greatly superior to that of the people of Singapore, given the economic conditions in each country respectively.

The paper by Piancastelli (2001) conducts an analysis for a broad number of countries for the years 1985-95. According to this methodology, the author seeks to estimate the expectable tax burden for a country, considering their structural conditions. The author proved that out of the variables under consideration, per capita income, the degree of openness of the economy in line with GDP, and the share of the agricultural sector in GDP are the most consistent variables that underlie the tax burden. This methodology comes close to our definition of structural potential, in terms of expected collection, and also enables countries to enjoy a greater tax effort than one, that is to say, that they effectively collect more than expected.

Chart 2 shows the outcomes from tax effort rates calculated for certain selected countries, measured by the relation between effective tax burden and the expected one (estimated by the author). Pursuant to Piancastelli, “any country with a rate greater than one is collecting more tax revenue than expected, given their economic, social and institutional conditions.” It is worth pointing out that the research paper only employed central government collection values, which may have underestimated the tax effort of federal countries.

Chart 2



Source: Piancastelli (2001) – Summary for 33 countries (original sample included 75 countries

Countries with an effort rate above one may be considered to have a legal potential above the structural potential of its economy (situation B analyzed above). From the original sample of 75 countries included in the study, a great majority of Western European countries fit into this category (based on the welfare state), but also included in this category are certain low income countries (Fiji and Kenya showed the greatest tax efforts of the overall sample). Just as in the previous study, the United States and Singapore evidence an effort rate below one, which expresses their decision not to tap their natural potential- a similar situation to that of other developed countries like Japan.

Note that we are not mentioning tax-evasion data. This does not imply that the countries with an effort rate above one suffer less evasion than countries with an effort below one. In order to make such an assertion, the legal potential estimation would be required. Also, we cannot assert that all the countries with an effort rate below one fit into what we have defined as situation A (structural potential greater than legal potential). The case may be that there are countries with a legal potential above the structural potential, but as tax evasion (tax gap) is very high, it generates an effective collection rate below the structural potential – leading to a tax effort lower than one.

Therefore, going further into our analysis, it becomes clear that, in addition to the consideration of structural potentials and tax effort, which provide a better comparative basis as to tax performance in each country, it is also necessary to pursue a measure of evasion or the tax gap. This measure, as mentioned before, shall render an estimation of the tax administration performance. Unfortunately, in this case, international measurements and estimations are less available, given the difficulty in estimating the legal potential by country and, moreover, evasion – a typically shadow phenomenon. We shall address this issue in the following section.

3. TAX POTENTIAL AS A GOAL OF REVENUE COLLECTION: REDUCING THE TAX GAP

Why should potential collection be a goal of the tax administration?

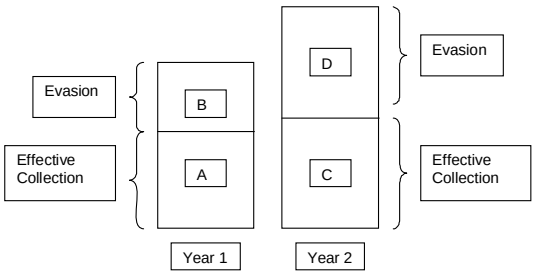
A tax administration may be defined as more effective the more it succeeds in reducing the gap between effective collection and the limited potential. In other words, the tax administration shall be more effective to the extent in which they succeed in minimizing the tax gap. This is based on the fact that it is not sufficient that a given volume of resources be allocated to

government coffers for the tax administration to fulfill their mission. In practice, the most important objective of a TA is to guarantee that all taxpayers be effectively compliant with their tax liabilities, as provided by law. Naturally, to meet the goal of Potential Collection would imply asserting the absence of evasion or inefficiency. Nevertheless, although it is a purely unattainable goal, to oversee and come close to it seems to be a clear objective for tax administrations.

In fact, and although the reduction in tax evasion and the increase in collection are correlating variables, evasion reduction from the standpoint of a performance indicator of tax administrations, seems to be greater than the increase in collection volume based on two reasons. Firstly, because the collected volume is influenced by variables foreign to the tax administration, such as the changes in tax legislation and economic performance. In countries with ever-changing legislation, it becomes difficult to break down the economic effect, the legislation effect and the tax administration effect of a given increase in collection. Secondly, from the management standpoint, it is not enough to compare the evolution of collection on its own base, since it may be quite reduced against the existing evasion in a country. In other words, a tax administration shall be judged especially on the basis of the efficacy in the efforts to counter evasion and the fair enforcement of the tax system for all taxpayers, instead of simply based on the collection performance.

Therefore, the tax administrator shall administrate the potential considering the full working spectrum. Figure 2 explains this. If a tax administrator only considers what he collects as a performance measurement, he may be easily fooled. Let us say that from one year to the next, effective collection has increased and this is interpreted as a good performance by a tax administration. Nevertheless, it may occur that its potential has increased even more, but, since he views only part of the potential, he fails to perceive that, in terms of efficacy, the performance of his tax administration is lagging behind.

Figure 2



In spite of the fact that C is greater than A, which indicates a good performance of the tax administration based on the easily observed parameter of the increase in collection, the relation between C/(C+D) is smaller than A/(A+B). That is to say, the tax potential increased and, in fact, in spite of a growth in collection, the tax administration is far from its goals, since evasion grew more in proportional terms. Even so, given the intrinsic difficulties in measuring evasion, the fact is that many countries disregard this variable as a performance parameter. Without the concepts shown herein, a tax administration may present an effective production, but shall not be fit to show effectiveness in their outcomes.

Therefore, in order to effectively tap the existing potential in full, the tax administration needs to analyze two different realities: that of collected revenue (and in what way it varies by effect of legislation, price and amounts) and that of income evasion (and to what extent it may be estimated and effectively approached to become permanent collected revenue).

Estimating Collected Revenue

The estimation of collected revenue serves the purpose of projecting the collection amount expected in the near future. This projection may be performed based on econometric methods or otherwise, and in general, considers and makes an attempt to identify the economic effects as well as the effects from changes in tax legislation on the overall revenue. Therefore, the starting point is the effective collection basis (or known) and the future revenue is estimated by applying economic parameters or trend analyses.

Certain tax administrations use the collection provision, plus a given collection effort as the institutional goal. Thus, the realized revenue divided by the expected revenue becomes one of the indicators of the tax administration efficacy. In Brazil, to set an example, the attainment of the goal set forth is an indicator for the additional compensation payment to tax administration officials.

Undoubtedly, this may be an indicator applied to the tax administration, but it must be always considered that, in this regard, it is a performance indicator relative to the known reality. In other words, this indicator provides an optimal reference with regards to past achievement and on how to improve the organization’s performance against the work carried out. In this regard, the good performance of collected revenue must be pursued at all times. Meanwhile, it must be clearly understood that this indicator

does not render the actual dimension of the actions still pending- that is, the magnitude of the tax gap or the potential that remains to be exploited.

Estimating the Tax Gap

In order to exploit the collection potential, it becomes vital not only to estimate the tax gap in amount terms, but also to analyze the composition thereof. It is relevant to highlight that a tax administration shall not succeed in exploiting their tax gap unless they work beyond the scope of their known universe, or based on the information already available. By its own definition, evasion refers to the shadow economy, not placed on the accounting records, and therefore, it spans significant work in terms of information sharing, analysis of geographical economic-tax indicators and by sectors, risk analysis, among other tools. The tax administration itself should be organized to pursue external information and conduct analysis thereof and not only work in the internal processes that are part of their standard procedures.

Since it is a concealed phenomenon, the tax gap is difficult to measure. The most commonly employed techniques for the estimation thereof are: comparing the tax base with data from national accounts or money supplies, use of data from audits conducted by the tax administration, opinion polls, and effects of tax exemptions granted.

Any of these methods and others available will not render an absolute figure per se, but they will at least provide the necessary order of magnitude for a tax administration to size its work. Additionally, should the same methodology be applied in time, it will also allow to define a tax evasion increase or drop rate.

As to the analysis of the tax gap composition, there are at least four dimensions that the tax administration should exploit: instrument, type of tax, sector and region.

The first approach delves on the type of instrument employed to succeed in evasion. In this regard, there are four different types of evasion: the non-compliant taxpayer (that is to say, typical evasion of the shadow economy that fully escapes the scope of the revenue agency and does not appear on their records); the registered taxpayer that does not file returns (that is, they exist on the records but fail to report on any economic activity); the taxpayer who files but not completely (that is to say, they resort to income under-filing or increases in expenses on the amounts

they file); and the taxpayer that files but does not meet payment or pays less than the amounts filed (that is to say, they only meet the secondary obligation but fail to meet the central one).

A second approach would be to identify the tax gap by type of tax evaded, precisely to assess the risk of every tax that is administrated, considering the cost-effectiveness of its collection. Certain taxes are known to be “easier to conceal” than others, considering the same tax administration capacity. Let us consider VAT as an example; since it is self-controlled, it is less evaded than income tax.

The type of revenue that is easily verified against third-party information and subject to mechanisms such as source retention is also less easily concealed than the types of income that are not subjected to said controls (for example, income from free-lance professions). In general terms, it is also reasonable to believe that simple legislations allow fewer chances of evasion if compared to very complex laws, whether because they are easier to understand by compliant taxpayers, or because of the increased difficulty for bad taxpayers to set up fraud schemes or benefit from legal loopholes. Therefore, not only the economic structure, but also the tax system structure itself may imply a larger or smaller tax gap, depending on the degree of sophistication and resources of a tax administration.

Thirdly, it is relevant to assess evasion by sectors. There is not one homogeneous tax evasion rate across all economic sectors. To the contrary, certain sectors are known to be traditionally difficult to control and monitor by the tax administration. For example, the agricultural sector, small businesses, freelance professions. It is no coincidence that the share of agriculture in the GDP is negatively linked to the structural potential. Also, depending on each country’s tax system, differentiated burdens may apply to different sectors, which also foster variable evasion rates across sectors, frequently in the pursuit of a balanced market competition.

There are also new sectors, which still lack the appropriate tax treatment; consequently, taxes imposed upon them are lower as to their share in a country’s economy. The services sector, especially the one related to e-commerce, may be a good example in the present.

The fourth approach would be the regional vision of evasion. Analogue to the analysis by sector, evasion also occurs heterogeneously based on national territory. There are regions in which taxes are imposed at rates that are either below or above the appropriate ones, there are regions marked by different economic characteristics (rural or urban economy made

up by small or large enterprises, with or without concentration by sectors, etc. , in other words, the analysis of the structural potential may be applied at the regional level, especially in countries with large territorial extensions and great regional diversity), there are regions with more or less oversight by the tax administration. All these factors come together to create different degrees of evasion in different geographical areas within a tax jurisdiction.

In summary, the exploitation of the tax potential requires data and analysis so as to identify what types of evasion prevail in a country, estimate the cost-benefit of each one of these types (in terms of difficulty and monitoring and oversight costs), so that the tax administration may effectively pursue the best strategy to reduce the tax gap. Sometimes, as discussed further herein, certain forms of evasion entail such a high cost to eliminate that it is not worth the investment by tax administrations to counter them, but only to monitor them, since they must face other situations involving greater revenue amounts and with a general impact.

International Empirical Data

As to tax gap estimation, an empirical example we may present is the effort by the United States Internal Revenue Service. The IRS also defines tax gap, as the difference between the amount that taxpayers should pay and what they have effectively paid. The methodology is based on a sample of returns, which are statistically valid as a cross section for the overall population. The IRS also seeks to estimate the gross and net tax gap, since the net value applies to the gross value less the overdue amounts paid or amounts paid following oversight and enforced collection. The most recently estimated values of the gross tax gap for the year 2001 ranged from US$ 312 to 353 billion and the net tax gap between US$ 257 and 298 billion. From these amounts it is possible to estimate the non-compliance rate or the tax gap against the overall collection – which accounted for 15% to 16.6%.[5]

As to composition, the IRS reports that 80% of their tax gap arises from taxpayers who file less than what they owe (in general based on reporting lower income), and that the omission (failure to file returns) and non-payment or payment of a lower amount account for 10% of the gap, respectively. Certainly this ranking may be different for less developed countries where, given an administrative restriction, a large number of taxpayers may even fail to file their tax returns as required.

[5] Source: www.irs.gov

Another study undertaken by the tax administration is the measurement of the tax gap by the United Kingdom HM Customs and Excise[2] . In this case, the methodology is directly applied to VAT. Two approaches have been implemented. In the top-down approach, the difference between the theoretical VAT amount and the effectively paid amounts is calculated. The bottom-up employs operational and intelligence data to verify the top-down approach and attributes the losses to specific problem-areas.

The VAT losses are attributed to errors, misinformation, abusive avoidance and deliberate fraud. The tax gap estimation is 15.8% for the 2002-2003 two-year term, and 12.9% for the 2003-2004 two-year term, which indicated a 3 percentage point reduction in the period. This could entail a good performance measure for the HM Customs and Excise in the years under analysis, after years in which the gap had increased. In fact, in line with our intention to set forth Potential Collection, or tax gap reduction as a goal of the tax administration, the HMRC has defined and published clear goals. For example, as to the VAT tax gap, the institutional goal is to cut it down to 11% up to the 2007-2008 two-year term. Certainly, the HMRC seeks to reduce their gap and somebody may ask whether it is feasible to adopt a zero goal. The pragmatic answer is that it is not reasonable to expect a zero tax gap, but it is reasonable to define the lowest possible goal, considering the cost-benefit ratio of guiding, overseeing and monitoring taxpayers, and even voluntary errors by taxpayers.

Giles (1999), using a different methodology in a theoretical study, calculated the tax gap for New Zealand, estimated within a range of 6.4% and 10.2%.

The aforementioned figures serve the purpose of rendering an approach as to the evasion values' estimations in developed countries that based on their economic, social and institutional features lead us to believe that they are low evasion levels. In the case of developing countries, the evasion level may be twice the figures mentioned above. In fact, according to Tanzi (2000, p. 25), "from the available literature one gathers that one third of the tax potential seems to be evaded in certain countries of Latin America and some Mediterranean countries."

In spite of the fact that many developing countries do not rely on accurate estimations of their tax gap, owing to the difficulties in calculating estimations because of lack of statistical information, we may have an idea of the probable magnitude of the gap based on estimations of the informal economy. The informal economy is to blame for part of the tax losses

[6] Source: www.customs.hmrc.gov.uk

suffered by a government administration; those taxpayers who, quite likely, have not even been registered in the tax administration. Surely, given the size of the informal economy, an average tax rate is deemed applicable, in order to estimate the possible tax gap, in the face of the lack of more sophisticated estimation mechanisms.

Arvate and Lucinda (2004) mention data estimated by Kinglmair and Schneider (2004) as to the informal economy. Specifically on Latin American countries, the estimations of the size of the informal economy as to the GDP are presented in Table 1. The average of the informal economy for the countries in the sample is 41% of GDP. We may observe that, certain countries with the highest indexes of informal economy (Bolivia and Peru, for example) also presented a tax burden below the structural potential, which underscores the aforementioned data.

Table 1
Informal Economy in Selected Countries

Country	Informal Economy*
Argentina	25.4
Bolivia	67.1
Brazil	39.8
Chile	19.8
Colombia	39.1
Costa Rica	26.2
Ecuador	34.4
Guatemala	51.5
Honduras	49.6
Jamaica	36.4
Mexico	30.1
Nicaragua	45.2
Panama	64.1
Peru	59.9
Dominican Republic	32.1
Uruguay	51.1
Venezuela	33.6
* as a percentage of GDP	

Source: Arvate and Lucinda (2004), originally quoting Kinglmair and Schneider (2004)

4. WHAT TYPE OF TAX ADMINISTRATION EFFECTIVELY EXPLOITS ITS TAX POTENTIAL?

Tax Potential and Risk Management

A tax administration that seeks to exploit their tax potential is, in practice, an organization that manages risk, since the great risk for a tax administration is evasion in its multiple forms and implications. This is so because it is evasion that leads to revenue losses, and also overwhelms a country's tax justice system and imposes costs on the tax administration. That is to say, the greater the evasion, the greater the risk that a tax administration be unable to fulfill their mission.

Risk management may be defined as a "formal process where risk factors for a specific context are systematically identified, analyzed, measured, organized and solved."[7] This entails a process by which an organization analyses its external environment, identifying and seeking to understand the risks that threaten it, and decides what policy may contribute to the management of said risks.

An organization does not necessarily have to tend to the reduction or complete elimination of all their risks, it is possible that certain risks have been administratively provided for already or fail to stand for a threat or are deemed irrelevant, or the cost-benefit thereof does not warrant taking actions against them. An organization may resort to four types of actions regarding the risks they are faced with: elimination of the risk (do away with exposure completely), risk control (reduction of the magnitude of the potential loss or the probability of occurrence thereof), risk transfer (such as, assurances or changes in legislation) and risk retention (decision to accept the risk provided it stays within an acceptable level).[8]

Why should Risk Management be applied on Tax Administration?

Specifically referring to the tax administrations of developing countries, the environment in which they operate is marked by characteristics that foster evasion or generate difficulties in the efforts to control it. Precisely, these are the characteristics that cause the structural tax potential in said countries to be, in general terms, lower than those in developing countries.

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7 OECD (a), p. 4.

8 University of Wisconsin, Risk Management Policy and Procedure Manual.

It is not by chance that many times developing countries have been pointed out for having a "weak tax culture." Tanzi and Zee [9] warn that the economic structures as well as the limited capacity of tax administrations are serious hurdles to overcome if the objective is to counter evasion.

Therefore, in what way can we succeed in the arduous task of countering evasion in an unfavorable structural environment with limited administrative and institutional capacity? The answer seems to describe the tax potential by means of risk management, understanding non-compliance in a number of forms.

A tax administration shall not only understand the existence of the different types and groups pertaining to evasion, but also the numerous reasons for non-compliance within each group and in what way each group may be disaggregated. It is only based on this understanding that the tax administration may define its strategies to counter (or otherwise) certain types of evasion, adapting their actions to every type or group of evading taxpayer.

The Type of Organization focused on Tax Gap Reduction

To this point, and according to all of the aforementioned, it seems clear that to establish a tax administration geared at the exploitation of the tax potential is not a simple task. Firstly, it requires data gathering and processing and the effective analysis thereof, which produces intelligence. This is more sophisticated than relying on a control database without feedback to the tax administration processes, which fails to meet the purpose of redirecting strategic actions and policies. That is to say, relying on data is not sufficient per se; they must be used intelligently to meet the tax potential goal.

Secondly, it is necessary to tear down paradigms that are almost traditional within tax administrations. For example, oversight efforts only geared at the known base of taxpayers, management indicators only based on past performance, only monitoring those economic sectors traditionally considered to bear the greatest tax capacity, among others. An administration of this type is never faced with new challenges, new fields for action, new sectors that develop in the economy often times because they are taxed at lower rates.

9 Tanzi and Zee (2000).

Thirdly, it is necessary to know the universe of risks before determining what instrument to adopt. A tax administration that does not know all its risks and has failed to determine the potential to be tapped is not in a position to efficiently allocate their resources between control (enforcement) and services (compliance), among different economic sectors or different geographical regions. For example, in the cases in which evasion is concentrated in small enterprises, maybe the initial approach may be geared at services, since non-compliance may have stemmed from complex legislation in force or the failure to access information. Nevertheless, should evasion be mostly concentrated in complex international fraud schemes, the approach shall be oversight and control, and not simply taxpayer assistance (services). In fact, as described by an OECD study, "In an ideal world, the revenue authority would know the relative compliance rates, revenue exposure and responsiveness of each of the client segments they have and would then make resource allocation decisions to various segment compliance-assistance and assurance programs based on this knowledge."[10]

In summary, every tax administration is faced with different risk situations and shall pursue a specific strategy for their problems. They shall analyze their external environment, understand and describe their risks and only then decide which tool would be the most suitable in terms of cost-benefit for the purpose of fulfilling their mission. In order to put that decision in didactical terms, we may imagine two fundamental spectra to analyze a tax administration: the tools spectrum (compliance spectrum[11]) and the strategies' spectrum (revenue authority administration spectrum[12]).

The Tools Spectrum

The tools spectrum summarizes the traditional dilemma of the tax administrations between investing proportionally more in services or control. This spectrum indicates, regarding tools available, which are the means for the tax administration to fulfill their mission. On one end of the spectrum we find a friendly tax administration that invests in services and education

10 "In an ideal world, the revenue authority would know the relative compliance rates, revenue exposure and responsiveness of each of the client segments they have and would then make resource allocation decisions to various segment compliance assistance and assurance programs based on this knowledge." OECD, p. 9.

11 Term mentioned by Sparrow (2000). Refer to pages 31-36.

12 Term mentioned by the OECD.

and approaches negotiations with taxpayers, mainly considering them as customers. On the other end, we find a strict tax administration, which basically seeks a punitive approach, considering taxpayers as potential evaders at all times.

Historically, developed countries have undergone a pendular movement along this spectrum. Since the early '90s, we have experienced the movement of the pendulum towards the services' end, largely influenced by the renewal movements from government administrations that determined administrative reform policies in these countries.

The Strategies Spectrum

"The degree according to which the tax administration focuses on risk management may be deemed an indication of the organization's standing along the revenue authority spectrum."[13] On one end of the spectrum we find a traditional tax administration, functions-oriented and with a high degree of segregation among them. On the other end, we find a tax administration that is strategically oriented according to the problems to be solved or the risks to be controlled. This tax administration features "systems, structures and approaches that acknowledge that taxpayers in different populations or groups usually face different problems or issues in their compliance with tax legislation, and may have significantly different opportunities and reasons not to abide by them."[14]

Figure 3 brings together both spectra to view in what way a tax administration is positioned along the tools' axis and the strategies' axis. In general, the reforms implemented by the tax administrations in recent years lead the organization to move along the tools' axis, moving to quadrants A or D (depending on their strategic direction focused on risk management to a greater or lesser extent). This movement could be applicable for situations of low potential gap or types of evasion related to the difficulty in understanding tax legislation and additional obligations. But it may occur that, in environments with a high tax gap and with sophisticated forms of evasion, the best strategy would be to focus on enhanced control. That is to say, the position to assume depends on the structural environment in which the tax administration operates and in what way it decides to reduce the tax gap.

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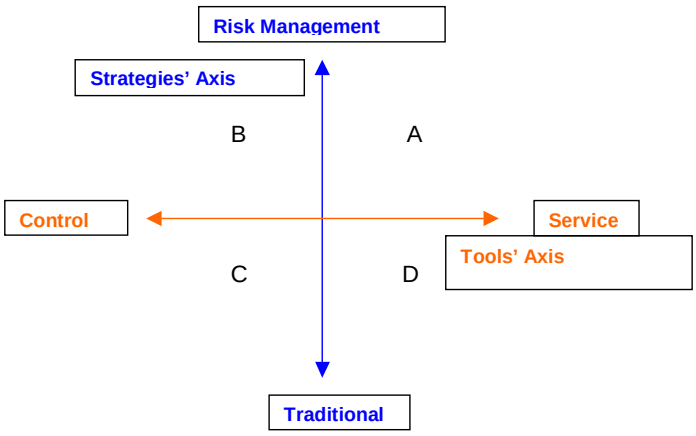
13 OECD (2001), Risk Management – Practice Note, Centre for Tax Policy and Administration, GAP003, p. 3.

14 Ibid.

Figure 3



5. CONCLUSIONS

This paper has analyzed the tax potential as a goal of the tax administration, especially, in the sense of pursuing a parameter by which said organization may set forth a measure of efficacy. The study of the tax potential leads us to define it according to two concepts: one structural, the other legal. To the extent in which reliable data were available, we presented empirical estimations to illustrate the practical application of these concepts, mostly as guidelines for strategic decision-making in terms of policy and tax administrations.

As to the structural concept, it is still considered that the tax system shall be implemented on a country's economic basis; the makeup of this basis influences and shapes the tax potential. Certain economic variables have a strong correlation with the tax burden and, therefore, may be considered as limitations of a country's structural potential. The analysis of this potential is relevant for the purpose of tax policy, to define the best strategy to pursue tax balance, whether based on revenue increases or spending cuts. As to the legal concept, it broadly stems from the collective decision of a society about what tax amount to pay to sustain the State, and therefore, the decision as to the size of State they wish.

Certain countries wish to have a State with a strong presence and the tax burden to sustain it demands a considerable tax effort as to the structural potential of the economy. Others prefer not to exploit the full structural potential available to them. Of course, there are also countries that, in spite of defining the legal framework to exploit the full structural potential, fail to do so because of their institutional inability, and end up with a tax burden extremely below both potentials.

It is worth highlighting that, should a country wish to define a legal potential above the structural one, they must be aware that they shall be imposing a tax effort on their society, and in the cases in which this effort is intense, it shall be sustained in the long-term only if the tax system and the public services offered in exchange are both of good quality. Otherwise, the tax gap is likely to grow, in line with the dissatisfaction of taxpayers in terms of tax fairness and economic efficiency, imposing control difficulties for the tax administration.

Therefore, the tax administration shall rely on this type of analysis to determine which is the best strategy to fulfill their mission. Once the tax gap reduction has been set forth as a goal, it is necessary to understand the magnitude and makeup of this gap, as well as the type of external environment in which this gap occurs (for example, of greater or lesser tax effort). Based on this analysis the tax administration shall be enabled to make sound decisions, even as to the type of tool (control or services) to use in order to meet its potential. This analysis trend is presently of utmost relevance, above all for tax administrations of developing countries, which are tasked with reducing the tax gap in an external environment (structural economic) quite favorable to evasion and with a limited institutional and administrative capacity.

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Case study

TOPIC 1.1

POTENTIAL TAX COLLECTION AS A TAX ADMINISTRATION GOAL

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ABSTRACT

This paper describes the procedures and methods used by the Federal Tax Administration for estimating, following up and analyzing tax collection. Estimating future resources is a decisive step in defining and planning the State fiscal policy, and the Tax Administration should prepare tax collection forecasts, regardless of the fact that some other government agencies

may be doing so as well. Counting with the Tax Administration's own estimates allows for more efficient follow-up and analysis of the tax collection process, so that it becomes possible to relate the Administration's Management Plan to the definition of the guidelines or goals set for the different levels of its own structure (tax collection management, audits, IT, etc.), thus maximizing the material and human resources focused on ensuring the collection of the projected resources.

Both the follow-up and the analysis of the tax collection evolution allow for the timely identification of variances from the projected figures, generating the necessary information for decision-making at the revenue administration.

In Argentina, the direct method is used for estimating projections. This method considers both the effects of changes in the economic variables and in the regulatory framework or some other changes which may affect the tax base. This method is combined with the application of statistic tools, such as the measurement of tax elasticity in connection to the variables impinging on the tax base.

The projection methodology comprises the following instances:

- **Tax collection standardization:** once the base year has been defined, adjustments are made to eliminate from the collection estimate those extraordinary factors which will not be recurrent in the projected period and, on the other hand, those factors which will exclusively take place during that period are included.
- **Tax projection**: once the tax collection standard has been obtained, the future tax collection is estimated on the basis of the evolution of the macroeconomic variable estimates which impinge on it. GDP and other macroeconomic aggregates are used, based on their correlation with the taxes to be forecast.
- **Incorporation of improvement factor:** a percentage figure is added based on the prospect of management improvement at the Revenue Administration.
- **Review and control:** the quality of projections and the efficiency of the method used are assessed, analyzing variances between actual and estimated tax collection, and pinpointing the rationale behind them. This last point is a feedback to the forecast system and improves it.

The projections cover monthly, annual and triennial periods, and they are daily followed up on the basis of a control chart designed for said purpose. Every month, the evolution of resources based on internal and external data is thoroughly analyzed, broken down into areas, economic activities and geographical location. The resource evolution is reviewed quarterly on the basis of macroeconomic variables (GDP, consumption, etc.).

INTRODUCTION.

The main source of revenues in most countries is taxes, social security contributions and Customs resources. The projection of tax collection basically seeks to contribute with the State fiscal policy planning process. This planning process is defined in the National Budget Act, which also includes the spending estimate.

The estimate of these resources may be made within the sphere of the Tax Administration or outside it. In our country, the projection of tax resources included in the National Budget Act is carried out by the Treasury Department which reports to the Ministry of Economy and Production, whereas the Federal Tax Administration is an independent body.

It is very important for Tax Administrations to count with their own revenue estimates, regardless of the fact that other government agencies be in charge of submitting the estimate to be included in the Budget, for the following reasons:

a) Estimating forecasts allows for a more efficient follow-up and analysis of the tax collection, since it presupposes good knowledge of the internal and external variables which affect the latter.

b) The fiscal administration should count with its own estimates in order to discuss with the Treasury Department about the actual possibilities of meeting the forecasts to be included in the State Budget, considering that these projections are the main goal to be met by the tax administration.

c) More than once, the managed resources may exceed the fiscal resources included in the National Budget Act[1] , making it necessary to count with an estimate of the latter.

[1] In Argentina, the Federal Revenue Administration (AFIP), is responsible for the fiscal resources included in the Budget Act and for the revenues corresponding to the Pension and Retirement Funds (AFJP), Social Welfare Funds, Workers Compensation Funds and other off-budget collections.

d) Estimating revenues allows for drawing the Tax Administration budget, in those cases where tax collection information should be provided therein, as is the case in Argentina.

e) The inclusion of own tax collection goals in the Management Plan of the Revenue Administration allows for setting up guidelines and goals for the different areas of its structure (audits, IT, etc.) thus maximizing the material and human resources available for meeting the first and foremost goal of the administration, which is ensuring the collection of the resources, as established on the basis of the State fiscal policy.

Following up on tax collection allows for the daily identification of variances from the projected figures. Analyzing tax collection makes it possible to account for its evolution in accordance with the different areas, economic activities, geographical location and macroeconomic aggregates.

The review and follow-up on tax collection are key elements both in the projection of resources and in their control, and are instrumental in improving the estimation methods employed and in accounting for variances, which in turn leads to the necessary information for decision-making.

1. TAX COLLECTION PROJECTION METHODS.

In general terms, the methods used for the projection of tax collection may be sorted out in two groups: statistical and econometric methods and direct method.

Statistical and econometric methods allow for obtaining revenue forecasts through their relation with the time variable (time series analysis) or with macroeconomic variables (elasticity) through the use of mathematical and/or statistical tools. These methods require the use of homogeneous information series which are relatively long and hardly capture normative changes such as changes in tax rates or tax bases, or discretionary changes such as changes in payment methods, changes in due dates, etc., and these limitations make these methods hard to apply in an unstable tax system.

The direct method considers the effects of changes in economic variables as well as normative changes and others which could affect the tax base. The use of this method presupposes good knowledge about the structure of each tax and about the economic process in each country. The disadvantage of this method is that it is more cumbersome than the others

and it requires thorough consideration of all the variables affecting taxes. In countries with dynamic tax systems, this method yields better results.

In general terms, these methods are not used in their pure nature, since in practice they are combined and one of both prevails.

Within the Federal Revenue Administration (AFIP), tax collection projections are made by the Department of Studies. These are used for the purpose of planning the Administration's activities, drawing its budget, since the latter is funded through a percentage of the collected revenues.

In general, the direct method is applied, including statistical tools, such as the measurement of tax elasticity in connection to the variables impinging on their tax bases.

Projections are made on a monthly, annual and triennial basis. They are daily followed up through a control chart designed for said purpose, where the daily revenue forecast is compared with the actual tax collection. This allows for analysis of variances and adjustment of projections.

1.1. Application of the method.

The estimation process used by AFIP consists of four parts:

- Standardization of tax collection,
- Revenue projection,
- Incorporation of the improvement factor in the Revenue Administration management and
- Review and control.

1.1.1. Tax collection standardization.

We define tax collection standardization as the adjustments made on collection, corresponding to those extraordinary factors which will not be recurrent in the projected year and to the incorporation of those factors which will be exclusively included in the projected year.

It should also be noted that it is necessary to identify the collection amounts whose perception does not correspond to the evolution of their tax base. This adjustment makes it possible to relate collection to the variables which impinge on it (GDP, consumption, etc.) doing away with the distorting factors of the relation.

In this stage of the estimation process the base year is defined, which is the standardized factor and is in general the most recent year[2].

In general terms, the adjustments geared at standardizing the collection process are the following:

- Normative or regulatory changes.

Any change in tax norms which may alter the amount or frequency of revenues should be measured and incorporated into the standardization process. Among these changes it is worth noting: tax rate changes, changes in the tax base, creation or elimination of exemptions, promotion regimes, changes in due dates, etc.

- Fragmentation of payment (payment facilities plans).

These plans are systems for payment of dues in installments. The revenues originating in payment facilities plans in force are distributed to the accounts of the different taxes on the basis of the origin of the reported debt.

The revenues originated in payment plans historically range between 1% and 3% of the total revenues. This item is adjusted if revenue changes are foreseen.

- Changes in taxpayers payment methods.

About 13% of the tax due is paid through offsets with positive balances for the taxpayer originated in other taxes. A change in the balance in favour of the taxpayers impinges on future offsets. Thus, foreseen changes in offsets are adjusted on the basis of balance amounts.

- Down payment estimates.

In our country it is possible, in specific cases, to compute as down payment all or part of the amounts corresponding to other taxes. These computations reduce the revenues corresponding to the projected tax, so that the foreseen variations should be properly adjusted.

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[2] Regardless of this, the standardization process covers a longer collection series with the purpose of measuring elasticities which will be used in the projection stage.

- Transfers between taxes.

When taxes have a specific allowance and besides admit offsets, as is the case in Argentina with the Tax on Liquid Fuels, the netting is reverted through accounting transfers. These distort the revenues corresponding to each tax, for which they should be adjusted.

- Extraordinary and out-of-term payments

When payments which will not be repeated in the projected year or which were received out of term are identified, they should be corrected if their amount justifies it.

This adjustment applies to specific payments and not to the usual arrears which is relatively stable throughout the years and which is already deducted from the tax collection of the base year. The arrears rate is only adjusted in the event of significant variation, due to factors such as the creation of some facilities payment plan, increase in the market credit cost, etc.

- Other adjustments

Allocation mistakes are also adjusted as well as any other value which may distort the tax revenues.

1.1.2. Projection of resources.

Once the tax collection has been standardized and the macroeconomic variables impinging on it have been estimated (independent variables), the new value of the tax collection is computed (dependent variable). The projections are made for each tax individually and the projection method for each one of the taxes may be summarized as follows:

$$\textbf{Collection}_1 = \textbf{Collection}_0 * (1 + c.r.i.v.* E)$$

where:

Collection_1: Equals to the estimated collection.

Collection_0: Standardized collection of the year prior to the estimated year.

c.r.i.v.: Change rate of the independent variable. It corresponds to the variation of the annual estimated unit of the macroeconomic aggregate with which the tax base of the tax bears a strong correlation. The variation of the projected aggregates is used in current values, so that they include the actual variation of the aggregate and of its implicit prices.

E: Elasticity of the tax regarding the independent variable (macroeconomic variable).

The estimated collection includes the rate of non-compliance[3] since it is computed based on the actual collection of the previous year. The reduction in the rate of non-compliance is included in the improvement factor of the Tax Administration.

Usually, only the GDP is used as independent variable for the estimation of all resources.

In general, the GDP is used in Argentina to make projections, but the correlation coefficient improves if another macroeconomic aggregate is used upon estimating other taxes. The selection of the independent variable should respond to its association with the tax base of the tax being estimated.

Tax collection and macroeconomic aggregates
Long-term, point and arch elasticity
Analyzed period: first quarter 1996 – fourth quarter 2005

Item	GDP	With other aggregates
VAT	0.92	0.97 1/
Excise duties	0.91	0.94 1/
Import duties	0.76	0.86 3/
Export duties 5/	0.82	0.89 4/

1/ with private consumption
2/ with monetary base
3/ with imports
4/ with exports
5/ analyzed period: first quarter 2003-fourth quarter 2005

Thus, the following related variables are used for projections:

- The VAT and excise duties are computed on the basis of private consumption.

- The Import and Export duties are estimated based on imports and exports, respectively.

[3] Non-compliance includes evasion and arrears.

- The current GDP is used in the estimation of the remaining resources.

The relation between these variables and tax collection may be quantified through the use of elasticity. The elasticities are estimated in connection to the previously defined variables and they measure the variations which occur in tax collection given certain changes in said variables, keeping the tax structure at a constant level.

The use of elasticity is not automatic, rather, it depends on the phase of the economic cycle during which the estimations are being made.

"Point" and "arch" elasticity are used as short-term elasticity measurements, and long-term elasticity is computed through the regression analysis. In the past years in Argentina short-term elasticities have differed from long-term elasticity, with the former yielding higher values than the latter. On the other hand, short-term elasticities are used, since the base year (standardized year) is generally the immediate previous year.

In Annex I details about the estimation method for elasticity are provided.

The next chart describes the estimated elasticities for the main taxes.

Tax collection and macroeconomic aggregates
Long-term, point and arch elasticity
Analyzed period: first quarter 1996 – fourth quarter 2005

Revenue Source	Long-term elasticity	Arch elasticity 2005 - 2003	Point elasticity 2005 - 2004
GDP			
Income tax	1.80	2.24	1.92
Tax on credits and debits	1.25	1.48	1.26
Social Security	0.99	1.81	1.72
Private Consumption			
VAT	1.21	1.43	1.13
Excise duties	1.19	1.65	1.15
Imports			
Import duties	0.76	0.66	0.71
Exports			
Export duties 1/	1.15	1.12	1.53

1/Analyzed period: first quarter 2003-fourth quarter 2005

It is worth noting that the elasticities in import duties are lower than one due to the fact that the tax base does not correspond to the total imports, since less than half of the products are levied.[4]

1.1.3. Incorporation of the improvement factor in the Tax Administration.

Once resources have been projected, a percentage is added accounting for the improvement prospects in the Administration management. The application of this percentage of administrative improvement includes concepts such as audits and collection management, which result in evasion and arrears reduction.

Unlike elasticity, this rate corresponds to future expectations and not to the relation of the variables in the past, for which they are a good complement.

The difficulty in applying this variable is that sometimes it is very hard to quantify the impact of some measures taken by the Administration in advance.

In some cases the improvement factor may be incorporated as a goal set due to the increase in tax pressure above the tax growth cycle.

1.1.4. Review and control.

The goal of this stage is evaluating the projection quality and the efficiency of the method employed.

For this purpose, the variances between actual and estimated collection are estimated, seeking the rationale behind them.

This analysis is carried out on an ongoing basis in order to feed back into the forecast system and improve it. If the reasons for the variances are permanent, their causes are incorporated into the model, reestimating the correlation coefficients and elasticity so that these may be included in future estimations. If the reasons have been an exception, the information is used in the analysis of post collection data.

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4 The imports originated in MERCOSUR are exempted, as well as most capital goods, aircrafts and vessels, temporary imports, electric power, fuels in general, etc.

1.2. Tax collection goal setting on a department basis.

The estimated collection amount is the overall measure and the latter is distributed among the operating, tax, social security and Customs departments of the Administration.

The goals are monthly distributed in the case of taxes and social security resources and annually distributed in the case of resources and taxes collected by Customs. The distribution of the overall goal is made on the basis of the smallest department[5] according to the collection capability that each department has, meaning the historical collection of the latter.

Tax collection estimation on a jurisdiction basis is made by reassigning payments by each taxpayer to the department corresponding to his or her fiscal domicile in the case of taxes and social security resources and, in the case of Customs resources, based on the Customs office through which the transaction which generated the payment was made. For this purpose, collection on a jurisdiction basis does not necessarily correspond to the place where the taxable event took place.

Tax collection is adjusted according to taxpayers jurisdiction changes (changes of domicile), exceptional and out-of-term payments. The adjustments are made based on the information generated for said purpose at the departments themselves.

Details about the goal distribution method are provided in Annex 2.

Charts are prepared on a monthly basis, explaining the level of goal attainment, broken down into department level.

2. FOLLOW-UP OF TAX ESTIMATES.

The follow-up on tax estimates is made daily through a control chart where the monthly projections are adjusted.

It is worth noting that regardless of the adjustments on estimates, the projections defined as goals to be attained by the Tax Administration are not changed.

5 AFIP is comprised of the General Tax Bureau (DGI), the General Bureau for Social Security Resources (DGRSS) and the General Customs Bureau (DGA). For operating purposes, DGI is divided into 3 areas with a total of 28 departments, which are in turn divided into 67 agencies, 67 districts and 5 processing units. On the other hand, DGA is divided into 2 Operations sub bureaus, 6 departments and 57 Customs offices.

2.1. Daily monitoring through a control chart.

The daily distribution is made based on the monthly estimate, taking into account the due date calendar for those taxes which fall due and the seasonality of revenues in the case of taxes which do not fall due, as is the case with Customs resources.

The daily projection is expressed on a control chart, where the actual daily tax collection is also incorporated, which allows for regular monitoring. The information on the different taxes is disaggregated according to their collection, through direct payment or withholdings, tax payments, Customs duties or Social Security contributions.

The control chart also reflects the daily developments, which will then be used in the collection analysis and in the standardization process. These developments include such things as accounting transfers, payment facilities distribution, tax deferrals, exceptional payments, down payments, etc.

The control chart includes the follow-up on Large Taxpayers revenues, who are 1100 taxpayers whose tax payments account for roughly 50% of the total taxes collected by AFIP. This information is received daily and includes details on each taxpayer, payments made and some data from the tax returns having to do with their tax assessment.

The individual follow-up on these taxpayers allows for immediate detection of missing payments, exceptional payments, payment deferrals or down payments, offsets, etc.

The control chart helps visualize the results of tax maturities and their variations on a yearly and monthly basis. It also shows the daily averages of Customs revenues and of taxes which do not fall due, as well as comparisons with other periods.

Based on the developments and the evolution of the taxes during their maturity, the monthly projection is adjusted, for which the adjustment frequency of the estimates is usually after each maturity date or in the event of extraordinary situations which call for it.

On Annex 3, an example is given of the follow-up on the Value Added Tax on the control chart during one month.

3. TAX COLLECTION ANALYSIS.

In order to analyze the evolution of tax collection, the latter is classified based on different aggregation criteria, making yearly comparisons and using external information. The evolution of the macroeconomic aggregates and their estimates are examined on a quarterly basis.

The analysis of tax collection is basically divided into the following classifications:

- Tax collection per item.
- Tax collection per economic activity.
- Tax collection per geographical distribution.

3.1. Tax collection per item.

The sorting of tax collection per item implies classifying the revenues based on each tax, or Social Security contribution or Customs duties, according to the payment method, through direct payment or withholdings.

Yearly comparisons of the monthly and annual accrued revenue are made with previous years, and with the information provided by the control chart, the causes for variations are sought.

This preliminary analysis is monthly circulated through a press release.

As information is received from the National Account System, the different resources are compared with the macroeconomic aggregates used in the projection in order to examine the evolution of the taxes during the quarter. The increase or reduction in relations is accounted for by analyzing normative or regulatory changes, changes in payment methods, increase or reduction in technical balances and surplus balances for the taxpayer, as well as changes in arrears situations or in tax payments, among other things.

The collection of the Value Added Tax is adjusted both for the purpose of knowing which are the causes behind the VAT consumption pressure and for comparing the latter with potential tax collection, seeking to measure the evolution of non-compliance (evasion and arrears).

Those adjustments which increase the actual collection are defined as non monetary revenues or deferrals of the tax which have reduced the

bank payments, whereas the adjustments which erode tax collection are those revenues generating surplus balances for the taxpayer, as well as pending fiscal credit rebates, among others.

From the comparison between the adjusted and potential tax collection[6], the amount of non-compliance is obtained on a yearly basis. This is an indicator of non-compliance in general, given the breadth of the tax base for this tax. (see Annex 4: methodological summary of non-compliance estimation for VAT).

3.2. Tax collection per economic activity.

Another classification which helps analyze collection is based on economic activity.

This classification allows seeing how much each economic sector contributes to the total collection, in absolute terms and in relation to the gross product or aggregated value generated by each sector.

The classification per economic activity responds to the structure, definitions and basic principles of the Uniform International Classification of all the Economic Activities (C.I.I.U. Review 3) and to the National Classification of Activities for the year 1997, prepared by the National Institute of Statistics and Census. The classification is based on the main activity reported by each taxpayer to the agency, including the income coming from secondary economic activities.

The existence of withholding systems for Customs resources hinder the classification based on economic activity. Therefore, in the case of direct taxes, such as Income Tax and Minimum Deemed Income Tax, the assessed tax is computed. On the other hand, in the case of indirect taxes such as VAT, the classification based on economic activity is made by estimating the amount on the basis of information obtained from the tax returns (See Annex 5, VAT classification based on economic activity). Reductions in pressure per activity generate, when no other explanation is found, more thorough studies and require reporting the differences to the auditing departments of the tax agency.

6 This equals the tax collection obtained if all taxpayers turned in their tax returns and paid all their corresponding taxes.

Customs collections are classified on the basis of their tariff status, monthly estimating the implicit tariff of the paid duties. Since the products respond to different tax rates, a change in the export or import structure generates changes on said tax rate. This analysis allows for spotting avoidance actions.

3.3. Tax collection based on geographical distribution.

The collection of taxes and social security and Customs resources is also classified on the basis of geographical distribution.

In the case of taxes and social security resources, the collection is assigned to the fiscal domicile of the taxpayer, which is real or legal in the case of individuals or legal entities, respectively. If said domicile does not coincide with the site of the address or with where the main and effective administration of their activities is, the latter shall be considered the fiscal domicile.

As far as Customs resources are concerned, the latter are computed on the basis of the location of the Customs office through which the transaction generating the payment is made.

Classification based on geographical location allows for following up on the tax collection evolution in the different provinces of the country.

Besides, based on the information obtained from the tax returns, other variables may be classified through this system as well, such as employers, employees, average wage, etc.

Once information is gathered on the economic structure of the provinces and their collection potential, on the basis of comparing the data on collection based on geographical distribution with the information on the economic activity, we can compare the evolution of these variables and, if there is any inconsistency, sectorial studies will be encouraged.

4. CONCLUSION.

The significance of tax resources in the attainment of the goals set in the State fiscal policy highlights the need for appropriate planning of those resources. The basic goal of the Tax Administration is ensuring the collection of resources, for which it must make a forecast of the latter, which in turn, allows for management planning in its different areas.

The methods used for making projections require not only the use of statistical technical and econometric tools, but also and basically, thorough knowledge about tax regulations, tax assessment and computation procedures and relations between tax collection and the economic aggregates and indicators which define their evolution. The follow up and analysis of the resource evolution compared with the established projections are a basic element in decision-making in the field of tax and fiscal policies, as well as in the management of the agency.

ANNEX 1

Methodology for estimating elasticity

In the stage of tax collection projection, the sensitivity to the changes in the variables is used. To this end, short and long-term elasticities are estimated.

The factor used to estimate short-term elasticity is point and arch elasticity, whereas regression models are applied for estimating long-term elasticity.

The **point elasticity** allows for analyzing the sensitivity of collection between two equidistant points in time in a given period, which is defined as follows:

$$E_{point} = \frac{\frac{\Delta T_{t+1}}{T_t}}{\frac{\Delta A_{t+1}}{A_t}}$$

where:

T_t tax collection during the studied period

ΔT_{t+1} variation in collection as a result of

A_t value of National Accounts aggregate during the period

ΔA_{t+1} change in the aggregate, estimated as follows

By means of the **arch elasticity,** we seek to measure the sensitivity between two equidistant points in time in more than one period. Its formal expression is as follc

$$E_{arch} = \frac{\frac{\Delta T_{t+k}}{T_t}}{\frac{\Delta A_{t+k}}{A_t}}$$

with $t \neq k$ and $k > 1$

This elasticity is an average of the collection sensitivity in the studied period and may be defined as medium-term elasticity.

With **long-term elasticity** we seek to obtain the collection sensitivity in a protracted period of time. For estimating the latter, a regression model based on minimum squared figures is applied.
The model of lineal regression is transformed using the following logarithm:

$$\log(T_t) = \hat{a} + \hat{a}_1 \log(A_{1t}) + \hat{a}_t$$

where:

tax collection during the period -dependent variable
α ordinate value at origin – constant term
regression coefficient
A_{1t} value of National Accounts aggregate chosen as explanatory variable for the period
ε_t random disturbance
t period under study

Thus, the estimated coefficient β_1 is interpreted as the percentage change expected in the dependent variable given the 1% increase in the explanatory variable, *ceteris paribus.* Long-term elasticity is defined as follows:

$$E_{lp} = \frac{\hat{\beta}_1}{\Delta_{A_1}}$$

with $\Delta_{A_1} = 1$÷

It is worth noting that in tax collection estimates based on regression of National Accounts aggregates we incorporated as explanatory variables self-regressive behaviours and mobile mean values recorded in the model residues. Likewise, for those series which presented a significant drop because of the crisis in the year 2001, a dummy variable was incorporated for that year as well, so that the long-term elasticity would not be affected by the atypical values recorded during that period.

All estimates are made on the basis of quarterly and annual data from the deseasonalized series considering the standardized tax collection, allocated to the accrual period.

These procedures lead to the definition of point elasticity, arch elasticity every two years and long-term elasticity based on the period between the first quarter of 1996 and the fourth quarter of 2005, except for those cases in which the tax was created on a later date. In this sense, the Minimum Deemed Income Tax was implemented in early 1999, whereas the tax on debits and credits and the Export duties were applied for the first time in the second quarter of 2001 and in mid 2002, respectively.

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ANNEX 2

Methods applied for the department-based distribution of overall goals

Below is a brief summary of the method for distributing overall goals:

Value Added Tax

The overall goal is distributed on the basis of the following formula:

$$Pi = 0,5*Ci + 0,5*Mi$$

The department is identified generically with the letter **i**.

Pi: percentage share of department i for the distribution of the monthly goal.

Ci: percentage share of department i in the collection during the month prior to the estimated goal.

Mi: percentage estimated on the basis of historical share of the department in total collection, as indicated below:

$$Mi = [a * Xi + (1-a) * Yi] * [1 + (b * Zi)]$$

where:

Xi: share of department in the collection of the same month of the previous year. In this way, seasonal factors affecting collection are taken into account.

Yi: average share of the department in the collection of the previous twelve months. We thus consider a broader historical share, mitigating the incidence of random factors such as climatic factors, etc.

Zi: percentage variation in the share of the department in the collection of the previous three available months. We thus take into account the structural changes which take place, such as changes in the department management, etc. The variation is estimated as follows:

$$Zi = \frac{\text{percentage share in 3 last months}}{\text{percentage share in 3 last months of previous year}}$$

a and b: parameters estimated in order to minimize the mean value of the absolute values in variances between the goal and the actual collection in each department. A and b are estimated on the basis of historical values of collection.

Tax on personal assets and Income Tax on individuals

In both cases, the distribution is made on the basis of the percentage share of the department in the previous last but one month, except in the case of months when tax returns fall due, where we consider the share of the department in the tax collection of the same month of the previous year.

Corporate income

The distribution is based on each department's share in the tax collection of the same month in the previous year.

Remaining taxes

The rest of the taxes are distributed on a department basis depending on the share they have had in the adjusted tax collection during the previous six months.

Social security resources

Social security resources are distributed based on the share of the department in the adjusted tax collection of the previous three months.

Customs resources and taxes collected by Customs

The goals of Customs resources and taxes collected by Customs are set annually and their distribution corresponds to the share of each department in the collection of the previous year.

By way of example, below we have included the comparative charts of collection with the goals in the regions of DGI and DGA.

Comparison of tax collection with goals. Total Social Security taxes and resources 1/

(thousand pesos)

ADMINISTRATIVE JURISDICTION	OVERALL TOTAL		
	Goal	Collected tax.	Compl. %
TAX GENERAL DIRECTORATE	**84,735,722**	**94,140,264**	**111.1**
SUBOFFICE OF TAX OPERATIONS I	**17,148,760**	**19,414,937**	**113.2**
Dirección Regional Centro	2,773,848	3,106,900	112.0
Dirección Regional Microcentro	3,665,395	4,116,897	112.3
Dirección Regional Norte	2,685,780	3,013,134	112.2
Dirección Regional Oeste	1,877,268	2,112,554	112.5
Dirección Regional Palermo	3,206,558	3,567,066	111.2
Dirección Regional Sur	1,950,328	2,252,281	115.5
Dirección Regional Devoluciones a Exportadores	989,583	1,246,104	125.9
SUBOFFICE OF TAX OPERATIONS II	**19,734,535**	**21,962,481**	**111.3**
Dirección Regional Bahía Blanca	650,146	798,043	122.7
Dirección Regional Comodoro Rivadavia	1,045,976	1,111,091	106.2
Dirección Regional Córdoba	2,826,379	3,070,954	108.7
Dirección Regional Junín	833,118	884,380	106.2
Dirección Regional La Plata	970,877	1,108,306	114.2
Dirección Regional Mar del Plata	901,575	951,695	105.6
Dirección Regional Mendoza	1,554,979	1,791,333	115.2
Dirección Regional Mercedes	1,080,499	1,177,264	109.0
Dirección Regional Neuquén	923,681	1,027,152	111.2
Dirección Regional Paraná	737,873	783,402	106.2
Dirección Regional Posadas	479,353	539,775	112.6
Dirección Regional Resistencia	592,845	671,246	113.2
Dirección Regional Río Cuarto	965,127	981,647	101.7
Dirección Regional Rosario I	1,468,217	1,592,435	108.5
Dirección Regional Rosario II	1,131,067	1,523,053	134.7
Dirección Regional Salta	502,676	583,855	116.1
Dirección Regional San Juan	481,830	575,780	119.5
Dirección Regional Santa Fe	1,596,788	1,735,728	108.7
Dirección Regional Tucumán	991,528	1,055,342	106.4
SUBOFFICE OF TAX OPERATIONS III	**47,852,427**	**52,693,856**	**110,1**
OFFICE OF LARGE TAXPAYERS	47,852,427	52,693,856	110.1
NOT ALLOCATED	-	68,990	-

1/ This does not include Social Welfare Funds, Remaining taxes and provincial Pension System

Comparison of collection with goals. Customs resources and taxes collected by Customs

Year 2005
(thousand pesos)

Administrative Jurisdiction	Goal	Collection	Comp. %
CUSTOMS GENERAL DIRECTORATE	**31,207**	**34,169**	**109.5**
METROPOLITAN CUSTOMS OPERATIONS	**15,216**	**17,037**	**112.0**
Customs Buenos Aires	11,362	12,710	111.9
Customs Ezeiza	3,854	4,327	112.3
INTERNAL CUSTOMS OPERATIONS	**15,992**	**17,133**	**107.1**
Region Comodoro Rivadavia	1,765	1,832	103.8
Region Córdoba	977	1,075	110.0
Region La Plata	5,317	5,779	108.7
Region Mendoza	1,021	1,085	106.2
Region Posadas	1,017	1,137	111.7
Region Rosario	5,894	6,226	105.6

ANNEX 3

Methodology for tax collection follow-up through the control chart

Below, we describe the methodology for the generation and use of the control chart, aimed at following up on tax collection. The description is made in general terms, and the particular case of the Value Added Tax has been added to illustrate the case.

1. Distribution of Estimates According to Tax - Item

The control chart is built incorporating the monthly and daily allocations of the annual estimates of each tax, discriminating each item according to the method of collection.

The VAT collection is disaggregated in direct DGI and DGA payments and DGI and DGA withholdings.

In those cases where the tax has a due date, the date of collection is also specified. In the example, for the collection of the balance in the VAT tax return, the payment dates are specified through the last numbers of the Sole Identification Code Number in the DGI direct payment section and the DGI withholdings paid fortnightly include two due dates for payment of the tax.

The daily allocation is computed on the basis of the monthly expected collection and of the seasonality during the month considered for the tax. In the case of taxes or resources with due dates, the seasonality is determined by the significance of the taxpayers and their due date by the last numbers of the Sole Tax Identification Code Number (CUIT for its acronym in Spanish). In the case of taxes without due date, as is the case of DGA VAT direct payments and withholdings, the distribution is made on the basis of the evolution of the monthly averages.

In all cases, the daily evolution is compared with the same period of the previous year, in order to detect any anomalies in the seasonality of the tax collection.

2. Data Feeding on Actual Tax Collection

The daily tax collection is fed into the chart as obtained for each tax and item. This information is obtained on the day following its collection and is compared with the estimate for the corresponding date.

3. Variance analysis

The differences between the expected and the actual collection are analysed in order to find the causes behind the variances, such as transfers between taxes, distribution of payment facilities or exceptional or out-of-term payments.

Thus, and coming back to the cited example, the DGI direct payment collection could have been lower than the expected collection because sums transferred to other taxes have been deducted from the tax account[1].

The obtained information is fed into the chart to be used in the post-collection analysis and in the tax collection standardization process.

4. Change Anticipation

Likewise, the Revenue Administration daily receives the payments made over the Internet by the taxpayers registered at the Office of Large National Taxpayers[2]. Since payments made on a certain day are credited on the following day, this information allows for estimating with a high level of certainty the tax collection which will be credited to the collecting bank accounts on the following day.

5. Estimate Correction

The evolution of collection is monitored through these tools, making the necessary adjustments on the monthly information on the basis of the developments and future information available.

VAT -Direct payment - Tax General Directorate - In million pesos

DATE	Dec. 17- 05 Saturday	Dec.18-05 Sunday	Dec.19-05 Monday	Dec.20- 05 Tuesday	Dec. 21-05 Wednesday	Dec. 22-05 Thursday	Dec.23- 05 Friday	Dec. 24-05 Saturday	Dec.25- 05 Sunday	Dec.26- 05 Monday	Dec. 27-05 Tuesday	Dec. 28-05 Wednesday	Dec. 29-05 Thursday	Dec. 30-05 Friday	Dec. 31-05 Saturday	Total
DUE DATES				Return Balance (cuit ending in 0 and 1)	Return Balance (cuit ending in 2 and 3)	Return Balance (cuit ending in 4 and 5)	Return Balance (cuit ending in 6 and 7)			Return Balance (cuit ending in 8 and 9)						
DAILY ESTIMATE			50,0	205,0	210,0	220,0	205,0			220,0	40,0	25,5	20,0	20,0		1.380,0
COLLECTION	0,0	0,0	47,0	187,5	175,6	218,5	211,2	0,0	0,0	251,1	39,8	36,2	31,6	28,0	0,0	1.399,0
INTERNET PAYMENTS	0,0	0,0	12,5	94,2	83,6	83,0	107,9	0,0	0,0	132,0	4,4	12,5	16,2	9,3	0,0	
INTERNET/COLLECTION			26,6%	50,2%	47,6%	38,0%	51,1%			52,6%	11,0%	34,6%	51,4%	33,2%		
EST/ACTUAL DIFFERENCE			3,0	17,5	34,4	1,5	-6,2			-31,1	0,2	-11,2	-11,6	-8,0		-19,0
NEWS																
Transfers				-20,00	-25,70					30,00						
Payment facilities distribution				Transfer to Fuels								Extraordinary Payment Business XX				
Excep. payments												11,06	11,36	5,93		
Others									Moratorium Distribution							

DATE	Dec. 17-04 Friday	Dec.18-04 Saturday	Dec. 19-04 Sunday	Dec. 20-04 Monday	Dec. 21-04 Tuesday	Dec. 22-04 Wednesday	Dec. 25-04 Thursday	Dec. 23-04 Friday	Dec. 24-04 Saturday	Dec. 26-04 Monday	Dec. 27-04 Tuesday	Dec. 28-04 Wednesday	Dec. 29-04 Thursday	Dec. 30-04 Friday	Dec.31- 04 Saturday	Total
DUE DATES	Sdo. DDjj (cuits termi-nadosen 0y1)			Sdo. DDjj (cuits termi-nadosen 0y1)	Sdo. DDjj (cuits termi-nadosen 0y1)	Sdo. DDjj (cuits termi-nadosen 0y1)	Sdo. DDjj (cuits termi-nadosen 0y1	Sdo. DDjj (cuits termi-nadosen 0y1)								
DAILY ESTIMATE	180,0			140,0	160,0	180,0	230,0	16,0	10,0	36,0	61,0	32,0	22,0	1.169,0		
COLLECTION	176,8	0,0	0,0	146,8	143,0	158,2	243,8	16,0	0,0	0,0	12,9	48,3	20,4	34,2	17,1	1.162,8
CHECKS	86,5	0,0	0,0	57,9	56,9	48,8	165,7	3,5	0,0	0,0	0,8	0,0	9,1	23,9	11,4	
CHECKS/COLLECTION	49,2%			39,4%	39,8%	31,2%	68,0%	21,8%			6,4%	0,0%	44,3%	70,1%	66,9%	
EST/ACTUAL DIFFERENCE	4,2			-6,8	7,0	3,8	-13,8	-1,0			-2,8	-8,3	40,8	-2,2	4,8	17,2
NEWS																
Transfers																
Payment facilities distribution													30,00			
Excep. Payments												Moratorium Distribution				
Others																

DGI (Revenue Administration) Withholdings - In million pesos

DATE	Dec.12- 05 Monday	Dec.13- 05 Tuesday	Dec.14- 05 Wednesday	Dec.15- 05 Thursday	Dec.16- 05 Friday	Dec.17- 05 Saturday	Dec.18- 05 Sunday	Dec.19- 05 Monday	Dec.20- 05 Tuesday	Dec.21- 05 Wednesday	Dec.22- 05 Thursday	Dec.23- 05 Friday	Dec.24- 05 Saturday	Dec.25- 05 Sunday	Dec.26- 05 Monday	Dec.27- 05 Tuesday	Dec.28- 05 Wednesday	Dec.29- 05 Thursday	Dec.30- 05 Friday	Dec.31- 05 Saturday	Total
DUE DATES		1st entrance (in 0 and 3)	1 st entrance (in 4 and 6)	1 st entrance (in 7 and 9)							2nd entrance (in 0 and 3)	2nd entrance (in 4 and 6)			2nd entrance (in7 and 9)						
DAILY ESTIMATE	**38,0**	**135,0**	**130,0**	**145,0**	**10,0**			**5,0**	**10,0**	**30,0**	**115,0**	**110,0**			**115,0**	**10,0**	**4,0**	**3,0**	**4,0**		**891,0**
COLLECTION	**40,2**	**137,7**	**127,4**	**145,9**	**11,9**	**0,0**	**0,0**	**5,6**	**10,5**	**128,6**	**18,7**	**111,4**	**0,0**	**0,0**	**114,2**	**11,1**	**3,6**	**3,5**	**4,4**	**0,0**	**909,4**
INTERNET PAYMENTS	27,0	95,1	82,2	111,3	4,5	0,0	0,0	3,3	6,4	69,3	6,3	71,8	0,0	0,0	89,1	0,8	0,0	1,5	1,1	0,0	
INTERNET/COLLECTION	67,2%	69,7%	64,5%	76,3%	38,0%			59,0%	61,1%	53,9%	33,4%	64,5%			78,0%	6,8%	0,2%	41,2%	25,2%		
EST/ACTUAL DIFFERENCE																					
NEWS	**-2,2**	**-2,7**	**2,6**	**-0,9**	**-1,9**			**-0,6**	**-0,5**	**-98,6**	**96,3**	**-1,4**			**0,8**	**-1,1**	**0,4**	**-0,5**	**-0,4**		**-18,4**
Transfers										Businesses with CUIT ending in 0 and 3											
Payment facilities distribution										100,00											
Excep. payments																					
Others																					

DATE	Dec.12- 04 Monday	Dec.13- 04 Tuesday	Dec.14- 04 Wednesday	Dec.15- 04 Thursday	Dec.16- 04 Friday	Dec.17- 04 Saturday	Dec.18- 04 Sunday	Dec.19- 04 Monday	Dec.20- 04 Tuesday	Dec.21- 04 Wednesday	Dec.22- 04 Thursday	Dec.23- 04 Friday	Dec.24- 04 Saturday	Dec.25- 04 Sunday	Dec.26- 04 Monday	Dec.17- 04 Tuesday	Dec.28- 04 Wednesday	Dec.29- 04 Thursday	Dec.30- 04 Friday	Dec.31- 04 Saturday	Total
DUE DATES			1st entrance (in 0 and 3)	1st entrance (in 4 and 6)	1st entrance (in 7 and 9)							2nd entrance (in 0 and 3)				2 nd entrance (in 4 and 6)	2nd entrance (in 7 and 9)				
DAILY ESTIMATE		35,0	113,0	100,0	120,0	5,0			6,0	8,0	28,0	85,5	5,0			90,0	75,0	15,0	3,0	5,0	**717,5**
COLLECTION	**0,0**	**34,1**	**109,8**	**100,2**	**119,5**	**3,7**	**0,0**	**0,0**	**6,9**	**10,1**	**32,8**	**90,3**	**5,3**	**0,0**	**0,0**	**85,7**	**81,7**	**14,2**	**1,6**	**4,3**	**722,3**
CHECKS	0,0	14,2	76,8	63,0	87,5	0,5	0,0	0,0	5,1	6,4	17,1	60,1	1,9	0,0	0,0	63,0	58,9	8,3	0,2	1,1	
CHECKS/COLLECTION		41,7%	70,0%	62,9%	73,0%	14,8%			73,4%	62,9%	52,0%	66,6%	36,5%			73,5%	72,1%	58,7%	14,7%	24,7%	
EST/ACTUAL DIFFERENCE		**0,9**	**3,2**	**-0,2**	**0,5**	**1,3**			**-0,9**	**-2,1**	**-4,8**	**-6,3**	**-0,3**			**4,3**	**-6,7**	**0,8**	**1,4**	**0,7**	**-4,8**
NEWS																					
Transfers																					
Payment facilities distribution																					
Excep. Payments																					
Others																					

VAT . DGA (Customs Administration) Direct Payment - (In million pesos

DATE	Dec.15-05 Thursday	Dec.16-05 Friday	Dec.17-05 Saturday	Dec.18-05 Sunday	Dec.19-05 Monday	Dec.20-05 Tuesday	Dec.21-05 Wednesday	Dec.22-05 Thursday	Dec.23-05 Friday	Dec.24-05 Saturday	Dec.25-05 Sunday	Dec.26-05 Monday	Dec.27-05 Tuesday	Dec.28-05 Wednesday	Dec.29-05 Thursday	Dec.30-05 Friday	Dec.31-05 Saturday	Total
TAX COLLECTION	65,8	76,4	0,0	0,0	64,9	67,0	50,8	50,6	21,0	0,0	0,0	59,8	71,2	62,1	70,4	16,2	0,0	**1.217,8**
DAILY AVERAGE NEW	60,7	62,1			62,4	62,7	61,9	61,1	58,6			58,7	59,4	59,5	60,1	58,0		
Adjustements	Lack of Transmission Compesa Customs 10,3	10,3		Accreditation by transmission														

DATE	Dec. 15-04 Wednesday	Dec.16- 04 Thursday	Dec.17-04 Friday	Dec. 18-04 Saturday	Dec. 19-04 Sunday	Dec. 20- 04 Monday	Dec. 21-04 Tuesday	Dec. 22-04 Wednesday	Dec. 23-04 Thursday	Dec. 24-04 Friday	Dec. 25-04 Saturday	Dec. 26-04 Sunday	Dec. 27-04 Monday	Dec. 28-04 Tuesday	Dec. 29-04 Wednesday	Dec. 30-04 Thursday	Dec. 31-04 Friday	Total
TAX COLLECTION	52,0	51,9	40,0	0,0	0,0	53,5	59,0	47,4	26,0	2,5	0,0	0,0	54,8	48,3	55,6	24,2	0,0	**385,1**
DAILY AVERAGE NEW	52,2	52,2	51,2			51,3	51,9	51,6	50,0	47,2			47,6	47,6	48,0	46,9	44,8	

VAT . DGA (Customs Administration) withholdings- (In million pesos

DATE	Dec.15-05 Thursday	Dec.16-05 Friday	Dec.17-05 Saturday	Dec.18- 05 Sunday	Dec.19- 05 Monday	Dec.20- 05 Tuesday	Dec.21- 05 Wednesday	Dec.22- 05 Thursday	Dec.23- 05 Friday	Dec.24- 05 Saturday	Dec.25- 05 Sunday	Dec.26- 05 Monday	Dec.27- 05 Tuesday	Dec.28- 05 Wednesday	Dec.29- 05 Thursday	Dec.30- 05 Friday	Dec.31- 05 Saturday	Total
TAX COLLECTION	17,4	11,6	0,0	0,0	13,4	13,6	12,0	9,0	3,0	0,0	0,0	13,3	14,9	12,2	16,4	3,1	0,0	**248,2**
DAILY AVERAGE NEW	12,6	12,5			12,6	12,6	12,6	12,3	11,8			11,9	12,0	12,0	12,3	11,8		

DATE	Dec.15- 04 Wednesday	Dec.16- 04 Thursday	Dec.17- 04 Friday	Dec.18- 04 Saturday	Dec.19- 04 Sunday	Dec.20- 04 Monday	Dec.21- 04 Tuesday	Dec.22- 04 Wednesday	Dec.23- 04 Thursday	Dec.24- 04 Friday	Dec.25- 04 Saturday	Dec. 26- 04 Sunday	Dec.27- 04 Monday	Dec.28- 04 Tuesday	Dec.29- 05 Wednesday	Dec.30- 04 Thursday	Dec.31- 04 Friday	Total
TAX COLLECTION	10,0	11,0	7,9	0,0	0,0	9,7	11,7	9,1	5,6	0,5	0,0	0,0	11,0	11,3	13,3	4,7	0,0	**155,3**
DAILY AVERAGE NEW	10,0	10,1	9,9			9,9	10,0	9,9	9,7	9,1			9,2	9,3	9,5	9,3	8,9	

ANNEX 4

Methodological summary and results of non-compliance with VAT estimations

The estimate of non-compliance with VAT is made by comparing the actually received collection (actual collection[1]) with the collection which should have been attained if all legally bound taxpayers had declared and paid the full amount of the tax (potential collection).

Unpaid tax = potential collection – actual collection

Potential collection is the result of applying the different tax rates of the VAT to the theoretical levied base. The latter is estimated based on the final levied consumption (household consumption[2] minus exempted and unlevied consumption) to which is added the intermediate levied consumption of sectors producing exempted and unlevied goods, the taxed investment of sectors producing exempted and unlevied goods and the levied consumption of goods and services and investment of the public sector, since the VAT of said transactions cannot be deducted in later stages.

+ Levied end consumption
+ Levied intermediate consumption of sectors producing exempted goods
+ Levied investment of sectors producing exempted goods
+ Goods and services consumption and public sector investment

Levied base

The actual collection is adjusted with the purpose of comparing it with the potential collection. Adjustments consist of adding non banking payments to the received collection[3], down payments originated in other taxes and fiscal deferrals among others, deducting increases of technical and available balances, settlements with VAT balances in other taxes, drawbacks owed to exporters, etc.

(+) Non banking payments
(+) Computation of down payments originated in other taxes
(+) Fiscal deferrals
(-) Increases in technical and available balances
(-) Settlements with Vat balance in other taxes
(-) Owed drawbacks (net of those corresponding to previous periods)
(+ / -) Other adjustments

Adjustments on actual tax collection

9 Adjusted to make it comparable to the potential tax collection.

10 The Value Added Tax is a tax on consumption. Though applied to all stages of the process of production and commercialization of goods and services, with the possibility of deducting the tax paid until the previous stage, the tax impinges only once on the final price of the latter, which corresponds to the sum of the added values in each stage of the economic cycle. That is why it is possible to estimate the theoretical basis of the tax on the basis of the information on final consumption.

11 VAT settlements with balances originated in other taxes.

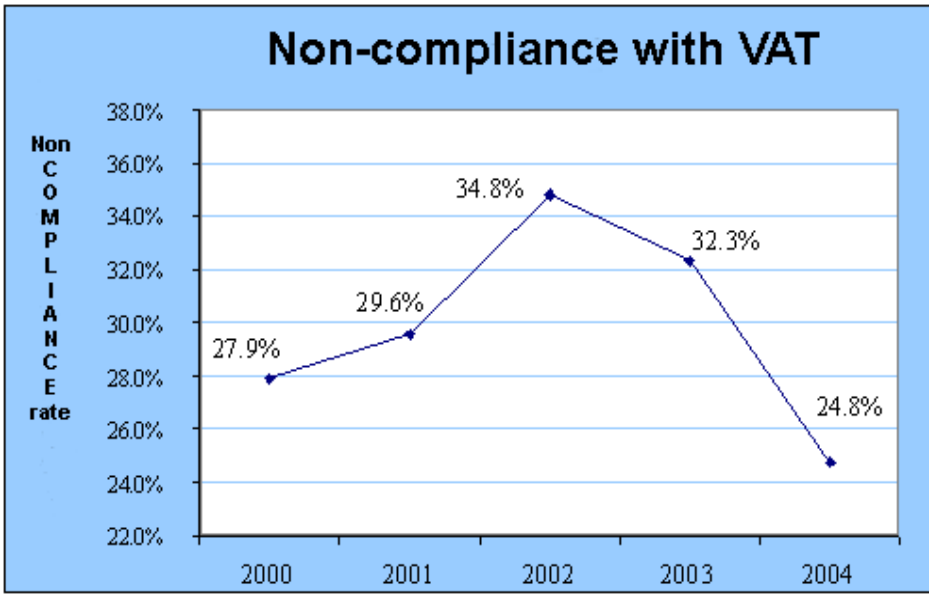
The non-compliance balance is then the difference between potential collection and actual collection. In relative terms it is defined as:

$$\text{Non-compliance \%} = \frac{\text{Potential collection} - \text{actual collection}}{\text{Potential collection}} * 100$$

Below is a chart showing the amounts involved in non-compliance with VAT in the past years:

VAT NON-COMPLIANCE ESTIMATE
Potential/actual tax collection. 2000 to 2004
In thousand pesos

Item	2000	2001	2002	2003	2004
POTENTIAL COLLECTION (A)	24,281,104	22,651,886	24,305,698	31,821,691	38,542,803
ACTUAL ADJUSTED COLLECTION (B)	17,507,175	15,951,530	15,836,045	21,545,103	28,992,953
NON-COMPLIANCE (C=A-B)	6,773,929	6,700,356	8,469,653	10,276,588	9,549,850
NON-COMPLIANCE % (E=C/A)	**27.9%**	**29.6%**	**34.8%**	**32.3%**	**24.8%**



Non-compliance with the VAT grew in the period studied until it reached a maximum level in the year 2002 of 34.8%. In the years 2003 and 2004 there was a sharp drop, and it reached in the last year the lowest level in the series, 24.8%.

ANNEX 5

1. Tax collection per item

Tax collection comparison chart
Years 2004 y 2005
Thousand pesos

item	2005 (253 Working days)	2004 (252Wrking Days)	Diference	
			Absolute Values	%
Overa llTotal	**132,024,713**	**108,301,284**	**23,723,429**	**21.9**
Taxes 1/	**86,704,064**	**71,946,171**	**14,757,893**	**20.5**
Gross VAT2/	**39,654,945**	**33,247,196**	**6,407,749**	**19.0**
DGI direct payments and withholdings	23,542,605	20,267,783	3,274,821	16,2
DGA direct payments and withholdings	16,112,341	12,979,413	3,132,928	24,1
VAT- net of rebates	**36,853,129**	**30,976,949**	**5,876,180**	**19.0**
Income	**28,045,399**	**22,289,094**	**5,756,305**	**25.8**
DGI direct payments and withholdings	26,902,307	21,401,917	5,500,390	25.7
DGA withholdings	1,143,092	887,177	255,915	28.8
Current Accounts	**9,434,291**	**7,681,862**	**1,752,429**	**22.8**
Liquid fuels CNG	**6,017,379**	**5,378,515**	**638,864**	**11.9**
Liquid fuels Except for gas oil diesel & kerosen	1,769,036	1,652,659	116,378	7.0
GNC & other fuels (gas oil, diesel & kerosene)	1,911,649	1,677,537	234,113	14.0
Tax on Gas Oil	1,834,552	1,565,806	268,745	17.2
Hydrostructure rate	341,369	327,282	14,087	4.3
Surcharge gas consumption	160,773	155,231	5,541	3.6
Excise duties	**3,665,597**	**3,040,618**	**624,979**	**20.6**
Tobacco	2,699,861	2,296,646	403,216	17.6
Rest	965,736	743,972	221,764	29.8
Additional Tax on cigarettes	**392,086**	**343,400**	**48,686**	**14.2**
Personal assets	**1,812,727**	**1,660,974**	**151,754**	**9.1**
Minimum deemed income	**1,102,188**	**1,223,618**	**-121,429**	**-9.9**
Single tax system - Tax resources	**756,922**	**499,377**	**257,546**	**51.6**
Rest	**509,346**	**415,737**	**93,609**	**22.5**
Tax on TV broadcasting /FM	140,046	115,479	24,567	21.3
Property tax	116,136	89,253	26,882	30.1
Ed.p Fund and coop.promotion	54,619	62,439	-7,820	-12.5
Tax on game of chance prizes	41,425	36,599	4,826	13.2
Tax on	28,836	28,176	660	2.3
Cinema tickets and videos	128,284	83,790	44,494	53.1
Others 3/				
Rebates, fiscal drawbacks, refunds (-)	**4,686,817**	**3,834,219**	**852,598**	**22.2**
Rebates	2,801,817	2,270,247	531,569	23.4
Fiscal drawbacks	1,885,000	1,564,000	321,000	20.5
Refunds on capital asset sales	0	-28	28	100.0
Social Security	**28,460,349**	**22,190,058**	**6,270,291**	**28.3**
Contributions (employees) 4/	13,348,505	10,166,890	3,181,615	31.3
Contributions (employers)	8,003,726	6,375,042	1,628,683	25.5
Social welfare funds	4,792,309	3,932,209	860,100	21.9
Workers compensation	1,724,237	1,259.934	464,304	36.9
Single-tax system. Social security resources	591.572	455.983	135,589	29.7
Payment facilities to be distributed /5	**111,415**	**188.339**	**-76,924**	**-40.8**
Customs resources /6	**16,748,885**	**13.976,715**	**2,772,169**	**19.8**
Foreign trade	**16,190,192**	**13,533.523**	**2,656,668**	**19.6**
Export duties	1,322,523	10,271,980	2,050,543	20.0
Import duties	3.780.338	3,168,370	611,968	19.3
Import statistics	96.225	82.083	14,142	17.2
Net converge factor	-8,894	11,090	-19,985	-180.2
Customs duties	**3,944**	**3,614**	**330**	**9.1**
Rest	**554,749**	**439,578**	**115,171**	**26.2**
Tax resources 7/	**119,252,412**	**98,285,153**	**20,967,259**	**21.3**

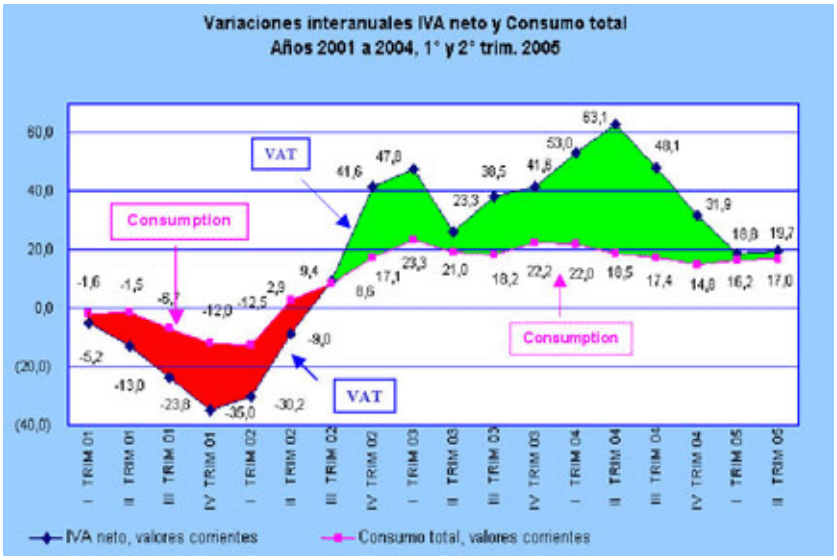
1/ Net collection of rebates, fiscal drawbacks and refunds.
2/ Gross collection without subtracting rebates, fiscal drawbacks and refunds.
3/ Includes paid interests and financial costs of business indebtedness, emergency over high profits, Vehicles, motorcycles, vessels and airships, assets, "pres.esp." and bills, seals and other minors.
4/ Includes Payment Facilities and Withholding Agents.
5/ Includes Decrees Nº 90/00, 963/95, 1053/96, 938/97, 1384/01 and 338/02 and Law 25.865 pending of distribution by concept.
6/ Does not include Income Tax, Value Added Tax, Internal Taxes nor Fuels Taxes collection.
7/ Net Tax Resources of Customs duties, Other Customs Collections, the Rest of Customs Resources, Social Works,

Collection of taxes, social security and customs resources
Relation with economic aggregates
Years 2002 to 2004. 1st, 2nd and 3rd quarter 2005

ITEM	2002	2003	2004	I Trim.	II Trim.	III Trim.	IV Trim.	I Trim.	II Trim.	III Trim.
OVERALL TOTAL/GDP	**17.84**	**21.10**	**24.19**	**22.98**	**26.34**	**24.65**	**22.60**	**24.81**	**25.04**	**24.86**
TAXES/GDP 1/	**11.51**	**13.65**	**16.11**	**14.62**	**18.85**	**15.85**	**14.86**	**15.95**	**17.35**	**15.76**
VAT Net of rebates/ Consumption	6.58	7.47	9.36	9.45	8.87	10.03	9.11	9.66	9.08	9.74
Income/ GDP	2.85	3.92	4.98	3.44	8.03	4.31	3.83	4.66	6.59	4.68
Current accounts/GDP	1.55	1.57	1.72	1.76	1.60	1.76	1.76	1.80	1.66	1.79
Excise duties / Consumption	0.76	0.80	0.92	0.98	0.78	0.90	1.02	1.01	0.89	0.91
Personal assets/ GDP	0.17	0.43	0.37	0.17	0.82	0.23	0.23	0.14	0.75	0.22
SOCIAL SECURITY/ GDP	4.30	4.42	4.96	5.53	4.25	5.48	4.68	5.81	4.41	5.76
Export duties / Exports	**6.25**	**10.78**	**10.17**	**9.23**	**10.98**	**10.37**	**9.91**	**10.32**	**11.69**	**10.75**
Import duties / Imports	4.53	5.60	4.82	**4.89**	**4.80**	**4.84**	**4.79**	**4.43**	**4.17**	**4.72**
Fiscal resources / GDP	**16.15**	**19.22**	**21.96**	**20.49**	**24.36**	**22.25**	**20.48**	**22.25**	**23.03**	**22.24**

1/ Collection net of rebates, drawbacks , and refunds

Title: Yearly variations – Net VAT and total consumption
Years 2001 to 2004 – first and second quarters of 2005



translation: Net VAT, current values Total consumption,, current values

COMPARISON OF TAX COLLECTION WITH TAX PROJECTIONS

Year 2005

Million pesos

ITEM	Goal	Collection	Compliance	
			Absolute values	(%)
OVERALL TOTAL	**106,834.4**	**119,252.4**	**12,417.9**	**111.6**
TAXES	**77,178.6**	**86,734.7**	**9,556.1**	**112.4**
VAT net of rebates	33,942.8	36,853.1	2,910.3	108.6
Drawbacks (-)	-1,530.7	-1,885.0	-354.3	123.1
Income	22,739.7	28,045.4	5.305.7	123.3
Single-tax syst.	707.7	756.9	49.2	107.0
Deemed min.income	944.9	1,102.2	157.2	116.6
Excise duties	3,537.0	3,657.4	120.4	103.4
Additional tax on cigarettes	413.2	392.1	-21.1	94.9
Fuels -gas	1,697.0	1,769.0	72.0	104.2
Fuels - Gas Oil	1,705.1	1,911.6	206.5	112.1
Other fuels	2,067.3	2,336.7	269.4	113.0
Personal assets	1,864.1	1.812.7	-51.4	97.2
Tax on credits and debits	8,706.7	9.434.3	727.6	108.4
Rest 1/	366.4	427.9	61.5	116.8
Others 2/	1.3	120.2	102.9	694.8
SOCIAL SECURITY	**14,540.7**	**16,327.5**	**1,786.8**	**112,3**
Contributions (employees) 3/	2,422.2	8,003.7	5,581.5	330,4
Contributions (employers) 4/	11,479.5	7,732.2	-3,747.3	67,4
Single-tax syst	639.0	591.6	-47.4	92,6
CUSTOMS RESOURCES 5/				
Foreign trades	**15,115.2**	**16,190.2**	**1,075.0**	**107.1**
Import duties	3,460.4	3,780.3	320.0	109.2
Export duties	11,551.3	12,322.5	771.2	106.7
Import statistics	103.5	96.2	-7.3	93.0
Convergence factor	-	-8.9	-	-

1/ Includes paid interests, Property transfers, Chance games prizes, Cinema Tickets and videos, AM/FM and TV broadcasting, Specific allowances.
2/ Includes emergency tax on high income and payment facilities, Decrees 93/00, 938/97, 1053/96, 963/95, 1384/01, 338/02.
3/ Does not include contributions to Retirement and Pension Funds.
4/ Includes contributions upon nourishing bonds, withholding agents, payment facilities, other social security accounts and Decree 2284/91
5/ Does not include collection of income tax, tax on fuels and VAT

2. II. Tax Collection Based on Economic Activity

As an example of tax collection information based on the economic sector, this annex shows collection of the Value Added Tax and Income Tax and other sources of revenues.

Value Added Tax

The estimate of the distribution of VAT collection based on economic activity is made using information obtained from the tax returns filed in by the taxpayers. The collection is allocated to the main reported activity on the part of the taxpayers to the Tax Administration. Main activity is defined as that through which the bulk of the income is obtained. Although on the VAT return some items are reported by disaggregating the amounts based on the involved activity, those used for generating the theoretical collection based on economic activity do not include said disaggregation (tax balance, withholdings and collections, down payments and others). For this purpose, the amounts of the tax generated by the secondary activities are allocated to the main activity.

The tax collection equals the sum of direct payment and withholdings, without deducting drawbacks. For this purpose it does not represent the tax pressure each sector bears, since the latter receives drawbacks of fiscal credit contained in the export transactions.

Gross VAT. Tax collection estimated on the basis of economic activity
Years 2004&2005
millions pesos

Economic activity	2005	2004	Dif.	Var. %
Total	**39,655**	**33,247**	**6,408**	**19,3**
A Agriculture, livestocking hunting & forestry	1,718	1,312	406	30.9
B Fisheries and related services	39	42	-3	-7.5
C Mine and quarry production	2,054	1,909	145	7.6
D Manufacturing industry	13,545	11,889	1,656	13.9
E Electricity, gas and water	1,269	1,169	100	8.5
F Construction	1,282	893	389	43.6
G Wholesale and retail trade, cars, Motorcycles and household Appliances repairs	8,817	7,310	1,506	20.6
H Hotel and restaurant services	405	304	102	33.5
I Transport, storage and communications	3,980	3,180	800	25.2
J Financial brokerage and other Financial services	2,490	1,972	517	26.2
K Real estate, business and rental services	3,002	2,335	666	28.5
Other activities	1,055	932	123	13.2

Income tax

Below we explain the relation between the Income Tax assessment in the last three fiscal years and the Gross Domestic Product. The generation of this information allowed for detecting a profit drop in the consolidated data of the tax returns filed in by the individuals in the agricultural, livestocking, hunting and forestry sectors, while the macroeconomic aggregates indicated 12.4% growth in the sector.

Export duties per sector

By way of example, below we provide the collection information on export duties per sector.

Export duties per sections according to the Mercosur Common Tariff List
Years 2004 & 2005

(thousands of current pesos)

Section	Denomination	2006	2004	Diference	VAR %
	Total	**12,322,523**	**10.271.980**	**2,050,543**	**20.0**
I	Live animals and animal products	507,614	507,614	112,399	28.4
II	Plant products	3,186,314	2,788,812	397,502	14.3
III	Animal or vegetable fats and oils, nutritional fats, animal or vegetable waxes	1,751,751	1,656,682	95,069	5.7
IV	Foodstuff industry products, beverages, Alcoholic liquids and vinegars, tobacco and tobacco by products	2,493,448	2,367,394	126,054	5.3
V	Mineral products	2,952,477	1,850,096	1,102,381	59.6
VI	Chemical industry or related products	272,161	237,177	34,984	14.8
VII	Plastic and manufactured products, rubber and manufactured products	153,926	123,555	30,371	24.6
VIII	Furs, leather and manufactured products, leather goods, Travel products, handbags or Similar containers	119,045	119,148	-104	-0.1
IX	Wood, charcoal and wood manufactured products, Cork and manufactured products, esparto products	33,594	27,357	6,237	22.8
X	Wood paste, or other cellulose fiber products, paper and cardboard for recycling (waste and residue), paper and cardboard products	60,921	61,349	-428	-0.7
XI	Textile materials and manufactured products	60,197	58,740	1,457	2.5
XII	Shoes, hats, umbrellas, walking-sticks, whips and their parts, prepared Feather products, artificial flowers Hair products	3,931	2,909	1,022	35.1
XIII	Stone, gypsum, concrete, asbestos, mica products or analogous materials, Ceramic products, glass and glass products	15,651	13,793	1,858	13.5
XIV	Natural or cultivated pearls, precious and semi-precious stones, Precious metals, metal plated products, Jewelry, coins	906	972	-66	-6.8
XV	Regular metals and their products	271,878	211,339	60,539	28.6
XVI	Machinery and equipment, electric equipment, sound recorders And players, image recorders and players, their parts And accessories	149,338	149,338	29,571	24,7
XVII	Transportation material	244,869	188,525	56,344	29,9
XVIII	Optics, photography and cinematography instruments and materials Measurement and precision materials, medical surgical instruments and equipment, their parts and accessories	16,409	10,919	5,490	50.3
XIX	Weapons, ammunition and their parts and accessories	1,348	1,263	85	6.7
XX	Trade goods and sundries	20,515	27,600	-7,085	-25.7
XXI	Works or art	336	195	141	72.6
	Unassigned antiques	5,894	9,173	-3,279	-35.7

Social security

Based on the information obtained from the Social Security tax returns filed in by the employers, we prepare, among others, reports on jobs and wages per sector.

Reported jobs and average wage per economic activity sector 1/ Year 2005

pesos

Economic activity of taxpaying business	Jobs	Av. wage	Variation % over 2004	
			Jobs	Av. wage
TOTAL	**5,375,020**	**1,200**	**11.4**	**13.2**
Goods producing sectors	**1,597,374**	**1,275**	**13.9**	**11.8**
Agriculture, livestocking, hunting and forestry	282,840	721	8.8	10.4
Fisheries and related services	16,361	1,944	2.5	6.5
Mining and quarry production	44,709	2,952	21.1	13.2
Manufacturing industry	970,005	1,460	10.0	13.0
Construction	283,458	884	36.3	11.8
Service producing sectors 2/	**3,653,483**	**1,176**	**10.8**	**13.6**
Electricity, Gas & Water	58,435	2,285	3.9	12.4
Wholesale and retail activities, automotive sector	753,779	1,039	12.3	15.2
Hotel and restaurant services	144,804	770	17.7	11.3
Transport, storage and communication services	390,769	1,526	10.9	14.3
Financial brokerage and other financial services	152,816	2,199	6.4	8.3
Business, real estate, rental services	551,198	1,022	17.3	12.5
Public service, defense and social security	631,571	1,320	8.3	18.1
Education	407.916	741	5.9	19.7
Social and health services	193,796	1,207	11.1	15.9
Community , social and personal services	368,082	1,087	8.5	7.9
Foreign organization services	318	2.,72	48.0	13.7
Unspecified activities 2/	**124,163**	**944**	**0.9**	**15.8**

1/ Includes information of the tax returns on the liquidation periods of September, October and November presented in their respective due months (excludes defective presentations outside the term).
2/ Includes public and private sector.

3. Tax collection based on geographical jurisdiction

The information on collection of taxes, social security and Customs resources is disaggregated per item and department. On this basis we estimate tax collection per province, whose annual total is given as an example.

Collection based on political jurisdiction
(Based on fiscal domicile or intervening Customs office)

Taxes 1/, social security and Customs resources
Years 2004 & 2005
thousand pesos

Jurisdiction	2005	2004
Total	**13,.600,115**	**111,947,163**
Buenos Aires	20,229,130	16,028,382
Ciudad de Buenos Aires 2/	84,164,447	69,928,098
Catamarca	202,089	153,025
Chaco	340,176	266,043
Chubut	1,990,467	1,337,497
Córdoba	5,112,413	4,154,237
Corrientes	1,321,554	1,064,736
Entre Ríos	1,021,816	833,578
Formosa	149,468	109,447
Jujuy	432,951	308,487
La Pampa	391,171	322,643
La Rioja	346,745	344,953
Mendoza	2,160,321	1,701,796
Misiones	|703,423	551,716
Neuquén	1,178,760	917,579
Río Negro	708,012	533,322
Salta	822,000	562,380
San Juan	547,341	392,574
San Luis	677,373	506,455
Santa Cruz	840,463	622,598
Santa Fe	11,497,739	9,772,991
Santiago del Estero	304,453	219,307
Tierra del Fuego	339,835	328,605
Tucumán	1,106,336	955,499
Unassigned 3/	**11,633**	**31,213**

1/ Gross collection
2/ Includes Large Taxpayers Dep.
3/Corresponds to collection of the tax on automotive vehicles, Motorcycles, boats and aircrafts and Convergence Factor
Data unavailable on a province basis.

The information obtained from the social security returns employed for analysing variations in the collection of these resources is also prepared on each jurisdiction.

National Social Security Regime. Pension and Retirement Integrated System

Private Sector, Jobs and gross wages per political jurisdiction.
Years 2004 & 2005 1/

Political jurisdiction	Jobs 2/	Gross wage (pesos) 2/	Yearly variation	
			jobs	Gross wage
Total	**4,488,287**	**1,416**	**1,416**	**14.6**
Buenos Aires	1,398,536	1,377	11.7	15.8
Ciudad de Buenos Aires	1,170,747	1,784	12.3	11.6
Catamarca	25,751	1,182	16.1	13.9
Chaco	46,616	1,024	14.4	15.3
Chubut	75,629	1,838	12.2	18.3
Córdoba	349,515	1,197	13.2	15.5
Corrientes	53,327	1,030	18.9	13.5
Entre Ríos	97,572	1,037	12.0	13.6
Formosa	16,733	966	31.0	14.3
Jujuy	41,553	1,043	7.1	19.6
La Pampa	29,534	1,120	10.9	15.3
La Rioja	23,684	1,115	16.7	12.1
Mendoza	178,655	1,110	11.2	17.2
Misiones	74,151	1,031	13.0	16.7
Neuquén	70,158	1,911	16.1	13.0
Río Negro	76,498	1,238	14.0	18.6
Salta	77,492	1,037	14.4	18.8
San Juan	55,705	1,136	13.0	22.4
San Luis	43,658	1,277	10.7	18.4
Santa Cruz	39,398	2,075	19.2	19.6
Santa Fé	383,913	1,203	11.6	15.9
Sgo. del Estero	30,709	915	12.3	16.0
Tierra del Fuego	22,726	2,052	15.6	19.3
Tucumán	106,029	1,033	13.2	15.1
Sin asignar				

1/ Includes information obtained from tax returns on periods fallen due in the indicated years, filed in during the month corresponding to the maturity of the tax (excludes presentations out of period)

2/ Monthly average

Case study

TOPIC 1.1

PROJECTION, FOLLOW-UP AND BEHAVIORAL ANALYSIS OF TAX COLLECTION

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1. VOLUNTARY COLLECTION

1.1 Premise.

The topic of voluntary tax payment has undergone a true revolution in legal, organizational and management terms over the past ten years.

Until 1998, relevant regulations on the matter were characterized by the monopoly granted to the concessionaires of the collection service, through which even the amounts taxpayers paid to other middlemen (banks and Post Offices) made their way before reaching the State Treasury. As a result, concessionaires derived significant gains, which did not add value in any effective way, since their work consisted solely in matching (according to a table provided by the Administration) the tax code indicated by the debtor in the payment form and the specific State account where all amounts paid should converge.

In addition, this kind of management did not ensure in the least a good relationship between the Tax Authority and the debtor: with few exceptions, if the amounts paid by the taxpayer reached the tax authority with some regularity, the quality of the data submitted to the Administration regarding each collection transaction was highly unsatisfactory. Said submissions were made on obsolete means (magnetic tapes) and within totally unacceptable terms.

Furthermore, it represented a substantial flaw of the conception of the legal regulations in force at the time, which were oriented exclusively toward checking the speed of monetary fund transfers while they paid little attention to the accuracy of the collection information, which should match the tax return proofs, as sent to the Administration.

This resulted in significant damage to the administration's activity, since failure to match the data between each return and the amounts collected led to undue debt records, which in turn led to taxpayer grievances and represented a very heavy burden for peripheral offices, which had to deal with a significant flow of public and attempt to solve the resulting situations on a case by case and manual basis.

Taxpayers, in turn, were unsatisfied because they received warnings which were often ungrounded, but also because during the period of voluntary compliance they had to face multiple due dates, which were different for each tax, and different payment forms, resulting in high rates of formal errors.

As from 1998, the Parliament and the office of the Head of Government worked jointly to eliminate these flaws and, to that end, a number of guidelines were followed both in the legislative and administrative fields, such as:

- Consolidating due dates for taxes and contributions;
- Unifying forms;
- Multiplying voluntary payment channels available for taxpayers, with the two-fold purpose of favoring compliance and reducing collection costs for the tax authority owing to the benefits of competition;
- Increasing the availability of electronic means of interrelation between collection middlemen and creditor Administrations;

In consideration of the above, I will next provide a brief overview of current voluntary payment regulations for the most relevant taxes.

1.2 Income Tax and VAT. Form F24 and Unified, Offset Payments.

1.2.1 Legislative Decree # 241/1997. Payment modalities and offsets.

As per Chapter III of Legislative Decree # 241 of 9 July 1997, taxpayers make voluntary payments of the most important taxes and contributions by granting an irrevocable authorization to one of the legally authorized representatives (banks, the Italian Post and other concessionaire corporations); in turn, the concessionaire receiving the payment transfers the amounts collected, upon deducting any applicable offsets, to the State Treasury. This system is called “unified payments.”

Taxes subject to unified, offset payments are income tax, value added tax (VAT), IRAP (regional tax on productive activities) and social security contributions, in addition to other taxes, fees and fines indicated in the Decree from the Ministry of Economy and Finance. For this reason, some tax obligations must be paid under the modality of reference because it is explicitly provided by law, but the Ministry of Economy and Finance might issue a decree from its own office to provide for additional taxes to be paid under said modality, thus ensuring flexibility margins which allow for an extension of the limits of the unified payments system by resorting to a simple administrative provision instead of a law.

Under this system, revenue must be deposited up to the 16th day of the due month. Thus, due dates for taxes payable monthly (VAT, source withholdings and social security contributions), which were formerly spread over several days of the month, were converged on the 16th day.

Conversely, specific deadlines were established for the payment of VAT and income tax outstanding balances and advance payments, for which an option might be made in the return to make them on a deferral basis by monthly installments of equal amounts, plus any interest applicable, provided the full payment was completed in November.

Regarding unified payment modalities, taxpayers fill out a single payment form, called “F24”, approved by a specific provision from the Financial Administration, which representatives make available for taxpayers.

In addition to the section containing the taxpayer’s personal data, the F24 form has another section for each Administration or group of Administrations, including a column for amounts to be debited and another column for amounts to be credited. Each amount should be accompanied by the corresponding tax code, which identifies the type of payment made, and by the reference period.

Debts may be offset against credits, their algebraic sum being the final balance, which cannot be negative, since the F24 is a payment form rather than a return and, therefore, it may not become a reimbursement request.

This brings us to the most important new feature in Legislative Decree # 241 of 1997: the possibility of offsetting debts against credits, both for taxes and active and passive items before the different recipient Administrations (State, Regions, local entities, social security entities) of unified payments. All of this allows taxpayers to “use up” their tax credits immediately, without having to wait until their annual return is examined and without prejudice, of course, of the Administration’s power to proceed to recuperate any credits deemed unduly offset during said examination.

In addition, offsets channeled through the F24 form do not cancel the possibilities of “internal” deduction of tax credits, in particular with regard to the power to deduct from the advance payment the credit arising from the balance of the previous year and to deduct from VAT and income tax payments the facilities granted to companies in the way of tax credits.

Notwithstanding, the institute of offsets does not reach all credits, but only those arising from regular returns. Other credits such as those arising from reimbursement requests due to duplications or payment exceptions are excluded.

In effect, the traditional procedure of verifying the relevance of credits previously may be replaced by the use of said credits as offsets, only on condition that said verification may be made at least *ex post* by controlling the effective existence of the credit at the time of comparing payment data with the tax return.

Another important measure approved in recent years is the possibility of using, for purposes of exempting tax obligations derived from self-assessment, means of payment different from cash, as foreseen in agreements with banks, the company Poste Italiane s.p.a. (the Italian Post) and the concessionaires. For example, it is possible to pay via a bank check. However, if said check were dishonored by the bank for lack of funds or any other reason, the tax obligation is deemed unpaid.

Over time and based on technological progress, the possibility of meeting tax obligations by means other than cash found increasing acceptance within the Italian system and was advanced by the Administration which, in effect, achieved a considerable increase in the use of said instruments.

Particularly widespread has been the practice of electronic payment over the *Internet*, debiting the checking account indicated by the taxpayer who should make a prior request for a personalized pin code to adhere to this method. On the other hand, resorting to this innovative means of payment also allowed for accountants to be included among collection representatives, on condition that their customers authorize them to make the corresponding debits from their checking accounts.

Payment over *Internet* is also done through notary publics in their capacity as responsible for the payment of taxes payable by the parties on real estate deeds of sale.

Likewise, I should stress that, for certain taxes which are neither collected by the F24 form nor over the Internet, such as taxes on vehicles, which are payable to the Regions, and the fee on radio and TV sets, payment “channels” have been extended by adding owners of tobacco sales stores to the list of collection agents, in which stores terminals were connected to the Administration’s IT system.

1.2.2 Relationships between Creditor Administrations and the "Management Structure."

From the standpoint of creditor Administrations, the most significant advantage of the "F24 system" is the electronic reception of the data contained in payment forms.

In this regard, it is useful to remember that electronic transmission of collection data represents only one of the two pillars of the so-called "Telematic Tax Bureau", in whose sphere IT processes for tax returns were also developed, which the Administration receives through IT flows coming from specific categories of authorized taxpayers, who receive compensation from the State in exchange for using this service. These are mostly banks, post offices, professionals and specific bodies (Tax Assistance Centers – CAF's) created by union and business organizations.

The aforementioned prompts that, regardless of the principles set forth in laws and regulations, a relevant part of the regulation on the relationship between the Administration and representatives (for example, the compensation amount, which is a fixed amount per form processed) and modalities for granting the authorization, developing the service and transmitting collection data is contained in specific agreements. This has determined a change in the legal nature of said relationship, which is currently ruled by private law, while in the past obligations undertaken by banks in managing payment authorizations of tax payments in the self-assessment system were ruled by public law.

Pursuant to the new regulations, the agent approached by the taxpayer to make payments follows the centralized modality and uses electronic means to deposit the amounts collected in a special account opened with the State Treasury, and transmits the corresponding data flow to the so-called "Management Body."

Upon receiving the data contained in the F24 Form, the latter builds back the gross value of the "net" payments made with the purpose of preventing the offset made by the taxpayer from damaging the allocation to each Administration of the amounts owed by them. Later, the same Management Body matches the monetary and IT flows and distributes the amounts deposited in said special account among the different Administrations based on the data it receives electronically.

It might happen that, on a certain payment date, the sum of amounts directed by taxpayers to one of the Administrations is not enough to cover the total credit of said Administration, since they were used as an offset. To prevent financial imbalances, however temporary, the opening of specific accounts has been foreseen to which the Management Body may resort to ensure each Administration receives regular cash flows.

It is in the framework of this procedure that one should understand the legislative provision of the taxpayer's duty to submit the F24 Form, even if the final balance is zero due to the effect of offsets made; failure to submit the authorization prevents due amounts from being attributed to one or more creditor Administrations, in cases where the offset was made relative to other Administrations, or if the credit was made under the rendering sheet in cases where the offset is made between taxes.

1.3 Fees and Excise Taxes. Form F23.

1.3.1 Legislative decree # 237/1997

With regard to minor taxes (in particular, fees and excise taxes different from value added tax, as well as a series of other charges, including non-tax charges), in December 1996 the Parliament instructed the office of the Head of Government to revise the regulations on the so-called autonomous cash services (ACS) of financial agencies. Said task was affected through Legislative Decree # 237 of 9 July 1997, which suppressed the ACSs and commissioned collection management of voluntary payments of the credits of reference (with a few residual exceptions, such as the fee on radio and television sets and mortgage fees) to the concessionaires of the collection service.

As a result, said payments might be made not only directly to the concessionaire but also at a post office or bank, which offices are in turn compelled to pay the amounts charged to concessionaires. These finally transfer the funds to the Administration. For this kind of payment, said concessionaires continue to be necessary collection representatives and receive compensation on exclusivity grounds, compensation which is calculated based on the number of lines in the form which have been completed by the taxpayer.

1.3.2 Payment form F23.

In compliance with Legislative Decree # 237 of 1997, payment form F23 was approved. Concessionaires, banks and post offices are compelled to make available for their customers the payment form F23 and which should be used pursuant to certain rules. In particular:

- When the payment obligation is originated by an Administration initiative, i.e. by a notice sent to the stakeholder (notice of settlement or notarization, infringement report or demand for payment), the office sending said notice shall attach an already filled out F23 form.

- To record an act, the taxpayer shall submit to the competent financial office, in addition to a sample of form F23 – through which the recorded tax has been paid – a model settlement containing a detailed list of taxes paid.

The representative through which the payment is made transfers the amounts collected to the Administration and sends the collection transaction data contained in the F23 form it received. This submission, however, is done following modalities which are totally different from those in the unified payment system, since in this case there is no body in charge of the functions performed by the Management Body to ensure an immediate matching of monetary and data flows and electronic management of collection data. The absence of such a Body further implies that taxpayers cannot offset debts against credits.

It is evident that, compared to Form 24, this payment procedure is much older and less advantageous for creditor Administrations and taxpayers alike. It is no coincidence, on the other hand, that in recent years we have witnessed a gradual departure from the use of the F23 form, with the shift of many fiscally important taxes such as the registry tax due on real property purchase and sale contracts, from the F23 system to F24 and payment via Internet. The F23 form is a merely residual payment instrument.

2. ENFORCED COLLECTION

2.1 Preliminary Considerations and Regulations on the Matter up to 1999.

Enforced collection is closely associated with voluntary collection, since correct and efficient voluntary collection ensures adequate persuasion levels and thus builds an unwavering guarantee to favor voluntary compliance with tax obligations.

From this perspective, for a long time there were no regulations on enforced collection of tax credits, since the burdensome mechanisms provided by the law ended up destroying the privileged position acknowledged in the abstract to public agencies, since the law gave the power to the concessionaries to prepare of their own accord, i.e. without previous control from the Legal Authority, an enforcement order (called “registry”). The collection of it, was claimed by the private entities related to the State through a concession relationship based on exceptions vis-à-vis the general regulations existing in the Italian legal system in connection with expropriation arising from delinquent debts.

The shortcomings of the regulations in force until 1999 may be summarized as follows:

1) Fixed frequencies in issuing registries, with the resulting activity peaks which had negative consequences in terms of management;

2) Slow exchange of information for purposes of identifying the property to be attached between the Administration and collection agents;

3) Failure to empower concessionaires to adopt essential precautionary measures, such as mortgages, in the civil field;

4) Accounting complications arising from the so-called “duty of treating the uncollected as collected”, i.e. the duty for concessionaires of different types of tax revenue to pay to the Administration the amount of the records allocated to it, regardless of whether the debtor had paid them. If the credit proved unenforceable over a two-year period, the concessionaire submitted a reimbursement request for the amounts advanced and, upon the resolution of said analysis (which entailed an extremely complex process), it recovered 90% of the amount advanced by means of a measure called “temporary charge-out.”

5) Lack of adjustment of regulations relative to Administration controls on concessionaires and procedures to recognize the unenforceability of the amounts stated in the registry.

6) Insufficient specialization of said entities on enforced collection, due to the fact that they are also responsible for managing voluntary payments (see item 1.1 above);

7) Remuneration of concessionaires unrelated to the outcome obtained in terms of collection volumes realized.

In this context, both the State and other public Administrations recovered a very humble percentage of their credits.

2.2 The 1999 Amendment.

2.2.1 Elimination of the duty of treating the uncollected as collected.

In an attempt to prevent this serious shortcoming from continuing over time, in the 1998-1999 period a process of deep reform of the enforced collection of tax credits was initiated by Delegation Law # 338 of 28 September 1998 and Legislative Decrees # 37 of 22 February 1999, # 46 of 26 February 1999 and # 112 of 13 April 1999.

Firstly, the institute of the duty of treating the uncollected as collected, of remote origin, was abolished. This institute, designed for collection purposes and as a motivation for the collection activity, proved unsuitable to meet these objectives and became, instead, as already stated, a source of serious accounting complications. Considering the chronic insufficiency of funds attributed as per the corresponding State expenditure budget items, it was accepted for concessionaires to benefit from the charge-outs tied to unenforceable records by offsetting them against the sums they had to advance on other records, giving rise to endless successions of “dragging” debit and credit items.

2.2.2 Collection by the registry.

Particularly interesting is the legislative technique described in the language of Legislative Decree # 46 of 1999. Before it became effective, provisions regarding enforced collection of public revenue different from direct taxes made reference to the regulations issued for said taxes, without too many

details. According to the general principles of our legal system, the operational capacity of a legislative reference finds an insurmountable limit in the compatibility of the provisions referred to by the regulatory micro-system in the sphere of which the reference itself is made. Thus, the absence of an explicit identification, in the legislative field, of exceptions to its operational capacity determined an ambiguous situation, where its concrete identification was entirely up to the interpreter. Naturally, this resulted in the risk of having each judge take different orientations.

In addition, for some time, identifying the revenues to be collected by the registry appeared extremely difficult in practice, inasmuch as it implied analyzing countless legal regulations on the subject, as well as administrative authorizations which were very difficult to standardize.

Instead, with Legislative Decree # 46/1999, all doubts on these issues were completely removed. Firstly, credits subject to enforced collection by the registry were identified by a comprehensive list, including all revenues pertaining to the State and other public entities, even the social security entities, excluding credits pertaining to economic public entities.

In truth, as far back as on 30 June 1999 the registry started to be used to make enforced collections of the credits pertaining to virtually all public entities, with a single significant exception: social security entities, for which enrolment in the registry was foreseen only as an additional option. Of these, the most widely used was the notice of payment addressed to the Legal Authority in accordance with the Civil Procedural Code. As a result of this, the most significant new feature, contained in Section 17, paragraph 1 lies in the obligation for social security entities to make enforced collections by the registry.

Conversely, regions and local entities simply have the power to opt for collection concessionaires. These Administrations may adopt a set of regulations to choose between collecting their revenue through concessionaires, by themselves or by appointing third parties selected by means of a competition at European level.

Considering the above in terms of the credits to be collected by means of the Registry, the aforementioned Legislative Decree # 46 of 1999 solved interpretation issues by providing that income tax regulations be applied to all the credits we have mentioned, save for the exceptions made specifically and in detail by the law.

2.2.3 Making the registries.

We should distinguish between ordinary and extraordinary registries.

Ordinary registries contain:

- Amounts owed after the “settlement” and “formal control” of the return which consist, respectively, in automatic and semi-automatic controls of the annual tax return;
- On an interim basis, part of the taxes the evasion of which were notified by means of an “audit notice”

On the other hand, extraordinary registries contain all due amounts based on the audit notice if they represent a grounded risk for collection. Registries are currently distributed among the different collection concessionaires, based on taxpayers’ tax domicile, which is mostly the same as their home address.

Income tax and excise taxes regulations were thus unified, while in the past, the corresponding registries were handed to the concessionaire of the province where the agency auditing the credit was located, which was not always the same as the debtor’s residence. Therefore, for said taxes, collection terms often became longer because it was necessary to resort with some frequency to the institute of “authorizations” between concessionaires, inasmuch as the notice for collection acts must always be made at the debtor’s fiscal domicile and, in turn, each concessionaire may only enforce collection in its own jurisdiction.

Regarding modalities for remitting the registries, current regulations (Ministerial Decree # 321 of 3 September 1999) set forth that the Administration shall send the registries to the competent concessionaire by electronic means through a compulsory private law consortium (the National Compulsory Concessionaires Consortium – CNC), while, with regard to the modalities for preparing the enforcement order, Administrations are allowed to resort to two alternative procedures: the “direct” procedure, whereby the public agency prepares the registries by itself, according to technical specifications, and the procedure which foresees support from the CNC.

In this regard, it should be highlighted that the Public Revenue Agency uses the direct procedure and thus manages the entirety of the registries’ life under the electronic modality. It uses electronic means to send all of its collection acts by registries (i.e. enrolment in the registry and any resulting

suspension measures, break-down into installments and deletion from the registry). This results, of course, in extremely positive effects in terms of expediency and efficiency of the management of the Public Revenue Agency.

Finally, financial agencies may issue enforcement orders on a day by bay basis, instead of on a consolidated basis in certain periods of the year as was the case until 1999. This brings about additional positive consequences in its organization.

2.2.4 Payment sheets and statutes of limitation for recovering credits included in the registry.

Submission of the Registry by the Administration to the concessionaire is absolutely internal between these two entities, the taxpayer having no knowledge about it. Later, taxpayers receive from the concessionaire the so-called “payment sheet”, which is basically a kind of copy of the registry.

In provisions in force until recently, the statute of limitation for enforced recovery of the most important taxes (income tax, VAT and IRAP) made reference to the time of enrolment in the registry by the financial entity rather than the time of notification of the payment sheet to the taxpayer. This was strongly rejected by the case law of the Court of Appeals and, in recent years, also by the Constitutional Court, which objected the lack of legal certainty and predictability derived for taxpayers and the resulting infringement of their right of defense.

Parliament took action in 2005 by introducing specific statutes of limitation relative to the date of notice of the payment sheet to the debtor, which were determined by establishing as the initial date the year of filing of the return. Specifically, said notice shall be made up to 31 December:

- Of the third year after the filing of the return, for amounts owed after the settlement;
- Of the fourth year after the filing of the return, for amounts owed after a formal control;
- Of the second year after that when the audit is considered final (by the taxpayer’s acceptance or as a result of the closure of the dispute), for amounts owed after the audit.

Likewise, exclusively regarding the relationship between the Administration and the concessionaire, the term within which the concessionaire shall notify the sheet has been set at 11 months as from the date the registry is delivered, to avoid incurring rejection of the request of recognition of the unenforceability of the credit (see item 2.2.8), i.e. responding affirmatively vis-à-vis the ultimate failure to collect.

Still with reference to the payment sheet, we should stress that it contains the warning for compliance with the obligation resulting from the registry within a 60-day term as from the notice, stating that, if noncompliance should persist, the taxpayer would be compelled to pay moratorium interest as from the notice date and the concessionaire shall proceed to expropriation and other coercive steps foreseen by law (see item 2.2.7.).

Nevertheless, the payment sheet does not only have a notification purpose but also an informative one, since it allows the debtor to become fully aware of the Administration's claims and if he/she considers it necessary, he/she may object said claims. Contrary to what happened in the past, current payment sheets are highly flexible in terms of their content, the flexibility makes it possible to produce all necessary data for the debtor to understand the grounds for the payment claim.

In this regard, I should point out that payment sheet instructions were worded with collaboration from university experts on communication in order to avoid the use of excessively technical language, be it legal or, worse still, bureaucratic.

2.2.5 "Partial collection" and suspension of collection.

Except in cases where the assumptions for issuing the so-called extraordinary registries are met (see item 2.2.3), the Italian legal system grants the Financial Administration, if there is a jurisdictional recourse against the audit notice underway, the power to collect on an interim basis a partial amount from the amounts audited, determined on a differential basis relative to the tax considered in each case (for example, 50% for income tax and for VAT) and to the status of the dispute.

Said "partial collection" is effected in a share of two thirds of the taxes and interest upon the appealable judgment and for the whole remaining amount upon the unappealable judgment.

The system we just described is evidently a kind of partial suspension *ex lege* of the collection of the amounts owed based on the audit notice. However, the Italian legal system, since as far back as 1996, also awards the taxpayer objecting the tax claim before the special judge (the Tax Committee) the possibility of requesting of said judge – both on amounts owed based on the notice and on those owed as a result of the settlement and formal control – to rule the suspension of the amounts stated in the registry until the conclusion of the trial. At the time of deciding on this request, the Tax Committee makes a summary assessment both of the grounds for the recourse and of the seriousness of the damage to the applicant in case the registry is enforced prior to the closure of the dispute.

Finally, the Public Administration is further empowered to suspend collection as a form of "self-protection", i.e. without an order from the judge:

- If the analysis of the exceptions submitted by the taxpayer lead the Administration to delete the record even on its own initiative, without awaiting the ruling by the Legal Authority;
- If exceptional situations are confirmed of a general nature or relative to a significant area in the jurisdiction, such as, for example, a natural disaster.

2.2.6 Postponement of payment.

Provisions in force until 1999 contained regulations which were not at all homogeneous relative to partial payment in installments, which contemplated different postponement possibilities, based on the type of record, the infringement which had given rise to it and the type of activity carried out by the debtor.

Current provisions, however, contain standardized regulations of the institute of partial payment in installments, relative to all State tax revenue. These set forth a relationship between the power granted to the financial agency of postponing the payment of amounts stated in the registry and the confirmation of the existence of a "temporary situation of objective difficulty". Said situation is defined as that whereby the taxpayer is prevented from paying the debt stated in the registry by a single payment, but can afford the financial burden derived from distributing the payment into a number of installments.

Upon acceptance of the postponement request – which shall be submitted before the beginning of the summary proceeding – either a maximum of 60 monthly installments may be obtained or suspension for a one-year period and, subsequently, a maximum of 48 monthly installments.

For amounts higher than approximately 25,000 euros, this benefit is subject to the filing of a fidelity bond or bank guarantee paid by the debtor, which the Administration shall accept only if granted by highly reliable parties, i.e. a bank or insurance company authorized to work in the area of securities.

2.2.7 Foreclosures and precautionary procedures

Concessionaires, unlike private creditors, which must resort to the judge, are empowered to manage in an autonomous fashion the foreclosure of both goods and chattels and property, unless objections are filed on the legality of the expropriation procedure. For the latter case there are a few significant restrictions in force allowing the debtor, the spouse, relatives or relatives to the third degree by marriage to show ownership of the goods or property attached in the debtor's home and business.

Evidently, the intention is to make these sales in a shorter timeframe. To render the administrative action more efficient, the minimum amount of 8,000 Euros of the credit recorded in the registry applies, at least in a prevalent manner, for the concessionaire to be entitled to make a real estate expropriation.

The concessionaire is further authorized to undertake another effective measure of a precautionary nature: foreclosure of taxpayers' property. The registry is, in effect, an enforcement order to file a legal mortgage on said property for an amount equivalent to double the total amounts recorded in the registry. In addition, for the filing of mortgages, the minimum credit amount of 8,000 Euros is not foreseen, which limit is therefore not a comfortable threshold in favor of debtors of amounts lower than 8,000 Euros. Although these debtors are not subject to property attachments, mortgages represent significant limitations vis-à-vis the free disposal of their property.

Still on precautionary measures, of great importance is the so-called "administrative restriction of use," which consists in the concessionaire's power to record in relevant public registries the prohibition of circulation of cars and motorcycles owned by the delinquent debtor. Were this prohibition infringed, the vehicle would be towed to an authorized warehouse. Considering the specific value of the use of cars, this measure proved to be especially useful in combating "evasion of collection."

By way of conclusion, it should be stressed that concessionaires are empowered to access the Public Administration's IT systems electronically, from the Financial Administration's system, which contains comprehensive data on taxpayers' income and, precisely for that reason, represents extremely valuable support in enforced collection of the credits recorded in the Registry.

This empowerment implied a radical change in the modalities and timing for obtaining data relative to the property and goods owned by the taxpayer recorded in the registry by concessionaires. In the past, these data were obtained slowly and by a rather complicated paper-based procedure – a "check" from the agency in the negative or insufficient attachment records and in those where the impossibility of placement is stated).

Current provisions seek to avoid dangerous and unlawful overlaps between the exercise of public service and ultimate private interests of the concessionaire by determining that data obtained by the concessionaire arising from the activity commissioned to it are reached by the secrecy of the function. Thus, their use for purposes other than collection of the credits stated in the registry has criminal sanctions.

2.2.8 Current organization of the relationship between the Administration and collection agents.

Regulations on this relationship are a highly sensitive issue in enforced collection and, precisely for this reason it shall undergo a historical evolution effective from next 1 October on.

Currently, concessionaires of the collection service may be corporations with paid up capital in an amount of approximately 2.6 million Euros, equipped with adequate IT systems with connectivity among them and vis-à-vis the Public Administration. Their exclusive purpose should be developing said enforced collection service and associated or complementary functions, as well as credit recovery which may be carried out by private entities through separate structures and pursuant to ordinary civil procedures.

Until 1999, the Administration mostly conducted formal audits of the concessionaires, which often confirmed minor accounting infringements. However, they did not find significant inefficiency; among other reasons, because the Administration lacked the data flows necessary to organize inspections with a specific purpose to allow it to take timely action.

In the organization created by Legislative Decree # 112/1999, however, concessionaires were compelled to send to each Administration detailed information on the collection of each one of the lines entrusted to them on a monthly basis. In addition, in the records of the Public Revenue Agency, this information is totally electronic – pursuant to the IT procedures ruling registry management – thus allowing for on-going, efficient monitoring of the progress of the activity.

Legislative Decree # 112 of 1999 also amended the regulations on the recognition by the Administration on the concessionaire's request of the unenforceability of the amounts recorded in the registry. Previously, unenforceability requests submitted by the concessionaires usually remained unanswered in the premises of the different creditor entities, thus rendering useless the sanctions on goods and property foreseen in the abstract for corporations failing to accurately document the unenforceability.

All of this was the result of the scarcity of staff appointed for this task and the considerable difficulty in analyzing this kind of requests, worsened by frequent extensions of the terms provided by law for complying with the various enforcement procedures.

Likewise, the old regulations on unenforceability denied the concessionaire the most basic autonomy to choose the expropriation actions to be conducted, forcing them, in practice, to try to prove the formal unenforceability of the record above all.

Huge prejudgments resulted from this; so much, even in isolated realities where enforceability requests were treated sooner, there was no growth of the collection volume *standards* – controlling the abundant paperwork which was attached to said requests was only useful to check whether from the analysis of the documents submitted, procedures were initiated or completed within certain timeframes.

Based on this situation, Legislative Decree # 112 of 1999 had tried to take a business view of the collection activity, freeing concessionaires from procedural terms and recognizing wide discretionality in defining the modes and terms of foreclosure and only penalizing the delay in notifying the sheet and the choice of enforcement actions which were blatantly unfit for the realization of the credit. As regards the remaining reasons for rejecting the unenforceability request, these are mainly infringements of the obligations to report, as a new confirmation of the importance attributed to said obligations.

In addition, in controlling unenforceability, the principle of silence-approval is applicable – once 3 years have elapsed since said communication, unless the Administration notifies a measure rejecting the charge-out request, the latter is considered accepted, with the resulting cancellation of the credit from the accounting records of the State and the concessionaire.

2.2.9 Inefficiency of concessionaires.

The provisions passed in the 1998 – 1999 period represented an extreme attempt at amending the system within the sector of reference, marked by the decision of more than a century ago, of entrusting enforced collection of public credits to private entities.

However, despite the efficient actions and deterrents recognized to these entities in that period, the business culture which prevailed in concessionaires was not one of seeking to maximize collection and transform their organizational structure and operational strategies as necessary to achieve said goal.

Basically, most concessionaires failed to make good use of the financial support measures offered for the first years of enforcement of the 1999 amendment, which ensured the same compensation levels attributed during the last two years of the old system, born by Government.

The organization of the enforced collection system thus implied considerable outlays of public money (approximately 500 million Euros per year) in favor of private entities, in addition to the economic costs arising from the IT exchange with the 38 concessionaires managing the provincial collection service, and administrative costs resulting from the surveillance to be performed by the Financial Administration currently vis-à-vis said concessionaires.

This resulted in a vicious circle, whereby concessionaires continued to request the allocation of global compensation born by the State while at the same time they obtained very scanty results from their enforcement collection efforts, so much almost all of the amount collected by the concessionaires consist in amounts paid voluntarily by taxpayers upon notice of the payment sheet.

In addition, banks, which are for the most part economic reference entities for concessionaires might face a conflict of interest between keeping a good relationship with their customer base and enforcing collection.

Finally, the on-going improvement of taxpayer assistance services, the increase in the number of electronic returns and the consolidation of voluntary compliance inevitably led to increasingly fewer records and, thus, the essential impossibility for concessionaires of reaching break-even merely through a percentage-based remuneration.

None of the above is to the detriment of the importance of enforced collection, considering that, as already mentioned, the State should increase the rate of voluntary compliance with tax obligations, even through the discouraging effect derived from an efficient system of enforced collection.

2.2.10 The recent shift of collection responsibility.

These are the reasons leading to the recent adoption of a new reform of the collection service, whereby, effective on next 1 October 2006, the service shall no longer be assigned to private entities through a concession but entrusted *ex lege* to a new corporation with majority shareholding by the State, *Riscossione s.p.a.,* whose majority shareholders shall be the Public Revenue Agency and the National Institute of Social Security (I.N.P.S.).

Said reform is a strategically important step in combating tax evasion, since it gives the Public Revenue Agency a key role in enforced collection efforts and thus ensures that auditing and collection by the registry are in line.

Standardized guidelines for the development of said activities shall increase both the efficiency and the persuasion power of the collection system. Furthermore, it is of utmost importance in this context to foresee the partnership of the INPS, since it is the second largest creditor entity of the record-based collection service by virtue of the number of registries assigned to it, following the Public Revenue Agency.

Decree-law 203 of 2005 should not be underestimated either, since it finally allows for overcoming the current atomization of the system, broken down into almost 40 companies, which leads to an easily imaginable anti-economic management arising from the differences among their IT systems, action strategies and supply policies.

In view of the above, it is necessary to highlight that, once the decision was made to shift the collection activity back to the public sector, the creation of a corporation to such end has been an almost imperative organizational solution to ensure the operational agility essential to the management of

enforced collection. This solution further allows for the staff working in this sector, currently amounting to 9000 people, to keep their specialization. Decree-law # 203 has encompassed the need to protect their legal and economic condition by further providing for the possibility of using, by way of a social buffer, a significant fund made up of prior contributions made by the sector's workers, which shall be available upon downsizing this headcount in the form of an early retirement of sorts, without the State incurring any expenditure in the process.

Likewise, special mechanisms were contemplated to ensure the transition from concessionaires to *Riscossione s.p.a.* does not affect organizational continuity, which is of course an absolute requirement given the highly sensitive nature of a service such as enforced collection of public credits.

All precautionary steps necessary were taken to "neutralize" the issues that might arise in transferring uncollected amounts (the so-called "management balances") from current concessionaires to the public *newco* and any interruptions in enforced collection.

Specifically, *Riscossione s.p.a* was given the option to purchase the share package of the concessionaires in whole or in part (never less than 51%). The purchase is conditioned to the simultaneous assignment of the shares to the shareholders of the concessionaires, for up to a limit of 49% of the capital stock.

Thus, the gradual passage of the enforced collection service to the public sector has been assured, since the existing corporations which become part of *Riscossione s.p.a.,* might continue operating without any transfers of management balances, even after the concession regime is terminated.

In effect, the new public corporation is legitimated to conduct the collection activity even through shareholders of no less than 51% of the capital stock. All of the above will allow *Riscossione s.p.a.* to start operating even before direct ownership is transferred, which takeover is planned for 1 October 2006, and be immediately empowered with every judgment element necessary to reach the goal of enhanced management as soon as possible.

This stage is transitory and shall conclude in 2010, with the repurchase by public shareholders of the shares of the *newco* previously assigned to private owners, as well as any minority shares in the concessionaire corporations which were purchased in part. After this date, the same public partners might proceed to sell 49% of the equity of *Riscossione s.p.a.* to private owners selected pursuant to public transparency standards.

In every other sense, the transfers we just outlined are functional not only to an evident need for continuity of the public function but also to the high complexity of the path drawn by the legislator, which shall involve 39 companies and thus give rise to what is likely to be the largest and most complex corporate consolidation transaction ever seen in our country, especially given that these 39 corporations make up a far from homogeneous group in terms of the organization of their IT systems, their policies regarding taxpayer delinquency management, expense policies, the accounting status, personnel costs and management, etc.

In this context, the Public Revenue Agency and the INPS, by a public act of 27 October 2005, first of all incorporated *Riscossione s.p.a.,* which was enrolled in the corporate registry on 31 October of the same year, and which has a capital stock of 150 million Euros, paid up in a proportion of 51% and 49% respectively.

Immediately after its incorporation, the *newco* started to meet its obligations as per Decree-law # 203 of 2005, focusing initially on the start-up of the complex merger and acquisition transaction of the corporation created as per the reform of the collection system.

The amendment provisions establish that *Riscossione s.p.a.* shall make a purchase proposal for the majority of the capital stock of the concessionaire corporations of the national collection service and the corresponding acquisitions shall be made until next 30 September, by which date, as already stated, the concession regime shall cease.

Once the acquisitions have been defined, the public *newco* shall start operating as a holding company of the corporations making enforced collection of the public credits. However, *Riscossione s.p.a.* shall not be limited to the mere management of the share packages acquired in the concessionaires, but rapidly undertake its own operational characteristic in order to ensure a positive impact in collection results in the short term and thus meet tax revenue objectives already set by Parliament for 2006.

This result shall be reached, effectively, through decisive intervention from *Riscossione s.p.a.* in the operating strategies of the acquired corporations, oriented to anticipating, to the largest extent possible, the effects of centralizing operating processes and the resulting enhancement of the collection performances which, according to Decree-law # 203/2005 shall be fully complete within a few years.

In this regard, an in-depth study has already been completed aimed at identifying best practices, and data pertaining to the obligations recorded in the registry have been processed, in addition to data on electronic collections made by the concessionaires, with a view to calculating the value of the net collections/cost ratio in the different provinces.

Later, based on a few structural parameters measuring the social and economic characteristics of each province (number of businesses, number of bankruptcies, tendency to tax evasion, etc.) and using a cluster analysis methodology, the national territory was divided into homogeneous types and, for each one, after excluding anomalous data, the best practices were identified and the tax revenue increases to be used as targets were calculated. The results of this study will allow *Riscossione s.p.a.* to orient the business policy of the corporations it is part of, in order to reach the objectives foreseen by Decree-law # 203 of 2005.

The other pillar to the enforced collection enhancement process lies in cost reduction. In this area too, *Riscossione s.p.a.* 's contributions will be very useful in connection with new management processes to overcome the current organizational and procedural atomization as well as initial steps in the direction of unifying IT systems and management criteria. These steps are essential in achieving economies of scale and paving the way for the projected mergers with the corporations that will be part of the *newco*.

2.2.11 Strengthening enforced collection procedures.

The considerations of the paragraph above are in connection with the innovations introduced by Decree-law # 203 of 2005 regarding responsibility for the public collection service, but the same decree further strengthened the exceptions to ordinary regulations on enforced collection of public credits.

In this regard, of particular relevance is the extension of the privileged procedure of attachments to include salaries, which was formerly foreseen only for rentals and leases: instead of requiring intervention by a judge, salaries may now also be attached by the order from the employer to pay the amounts due by virtue of the employment relationship directly to the concessionaire.

Enforced collection procedures are also strengthened by extending the power to access useful information for purposes of enforced collection, which might refer to all data, both in hands of private and public entities,

and these data may be used without complying with the special procedures provided for in the general regulations relative to privacy protection. This decision originated in the importance of the goal of the concessionaire's activity vis-à-vis data publicity, activity which shall be no less important once under the management of *Riscossione s.p.a.*

Finally, a very positive signal lies in the explicit contemplation of the collaboration from the Financial Guard in the collection activity, which is possible owing to the substantially public organization which shall result from the insourcing transaction planned under the reform.

Evidently, it is a highly relevant piece of news, owing to which *Riscossione s.p.a.* will receive the contribution of a highly specialized corps in combating evasion and use the valuable intelligence capability of the Financial Guard for enforcement and precautionary actions to be undertaken vis-à-vis delinquent taxpayers.

Case study

TOPIC 1.2

TAX EXPENDITURE: HOW TO MEASURE THE EROSION OF THE TAX BASE

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CONTENTS: 1. Tax Incentives.- 2. Export Incentives.- 3. Investment Incentives.- 3.1. Regional incentives.- 3.2. Incentives for sectors.- 4. Research and Development (R&D) Incentives.- 5. Incentives and Tax Benefits.- 6. Tax Expenditures.- 6.1. Difficulties in determining tax expenditures.- 6.2. Tax expenditure's strengths and weaknesses.- 6.3. Tax expenditures' reports of budgets.- 6.4. Tax expenditures in the USA.- Bibliography.

1. TAX INCENTIVES

The main objective of tax systems should be that of collecting the resources to finance government spending on a more efficient basis, as well as ensuring the equitable distribution of the tax burden. Governments still frequently avail themselves of tax systems to promote specific policies.

For a long time it has been a usual policy, in developed as well as developing countries, to grant tax incentives with different policy objectives such as, for example, the promotion of exports or foreign direct investment (FDI).

These incentives may be defined as those that, by reducing the tax burden companies are faced with, contribute to modify their behavior by encouraging them to invest in certain sectors or regions. They may be considered exceptions to the general tax regime. International research (UNCTAD, [2000]) shows that the reductions in the income tax rate and exemptions or tax holidays, are the most frequently granted tax incentives. They are followed by the reduction in machinery, equipment and indirect materials import duties; duty drawback systems; accelerated depreciation regimes; specific deductions for certain income from the income tax payment; deductions on reinvestment and reduction in social security contributions.

In developing countries, specifically, commercial policies have been replaced by tax incentives to attract foreign direct investment (Villela, Barreix [2002]). It seems clear that the role of these instruments is secondary, less relevant than factors such as the market size, infrastructure and country risk. The point has been and still is the object of numerous research efforts, and the strengths and weaknesses of tax incentives are still not clearly defined, since remarkable success stories are known, but also outright failures.

2. EXPORT INCENTIVES

Exports incentives have lost importance significantly, based on different reasons:

(i) because they are incompatible with and contrary to economic integration processes in which countries from Latin America and the Caribbean participate (CAN, CARICOM, MCCA and MERCOSUR), to the extent they introduce distortions in competition conditions;

(ii) although said agreements allowed the implementation of extra-market export incentives, the different tax responsibility programs have tended to reduce them;

(iii) the penalties applied by the importing countries following the rules of the World Trade Organization (WTO) also contributed to reinforce the reduction of these incentives.

On the other hand, given the current consensus on the fact that taxes may not be exported, the refund of indirect taxes paid in stages prior to exports may no longer be considered an incentive. The WTO allows the refund of said indirect taxes, provided the tax burden may be accurately calculated at the time of exporting.

3. INVESTMENT INCENTIVES

3.1. Regional Incentives

Incentives to the less developed regions are typical of countries with large extensions of land. Argentina, Brazil, Chile and Peru, for example, feature incentive programs for the development of certain regions: Tierra del Fuego and "Less Developed Provinces" -San Luis, Catamarca, La Rioja, San Juan and certain areas in Mendoza- in Argentina, Manaos, Amazonia and Northeastern Brazil, Inhospitable Areas (South and North) of Chile and the Peruvian Amazonia.

Incentives of this kind tend to be implemented in regions with comparative disadvantages given their distance from the main urban areas. Activities in these regions generally imply higher transportation and communications costs, which increase production and distribution costs. They may even imply additional costs to relocate labor in the region, which will call for higher salaries to move people to a region that lacks the services of urban areas.

International experience indicates that the first best is that the government develops the infrastructure in the area. As second best, the government could reward the investor for the cost of infrastructure development and training employees from the region, with employment subsidies instead of income tax reductions.

3.2. Incentives for Sectors

Certain countries, especially Asian, grant tax incentives –or of another nature- to investment in certain sectors, considered strategic for development. These incentives are more of an industrial policy instrument, that is to say, they pursue the development of certain activities, and not so much investment incentives, specifically, foreign direct investment.

The implicit rationale in the granting of incentives to sectors considered strategic is to overcome the market's failure to reflect future income stemming from the drop in unit costs in line with the sector's development. In time, with the increase in production, unit costs drop and the country gains a comparative advantage with the development of the benefiting industry. This is the classic argument to warrant protection of infant industry.

In order to be effective, these incentives must be directly geared at small companies in the middle of their expansion process, which generally lack access to credit markets, and must be appropriately selected: for example, reductions in the income tax rate or tax holidays are less efficient than fiscal credits that provide financing in advance.

Most of the tax incentives for sectors granted by developing countries are linked to the investment in the manufacturing industry, mining industry and, increasingly, tourism and related services.

Costa Rica, for example, applies tourism incentives for hotels, tourist transportation, travel agencies and car rentals. Singapore grants income tax for a 5-year term to companies that operate in less developed sectors of industry. The cases of Malaysia, Singapore and Philippines are exceptional in the sense they offer income tax reductions to services companies, a sector where this type of incentive is uncommon in developing countries.

International experience indicates that it is very difficult to succeed in developing this incentives' program. If the regime is discretionary, it becomes vulnerable to political pressure, lobbies and grafts, and if the regime is discretionary as well as automatic, bad decisions may be made in the selection of the beneficiary sectors, as was the case of Korea 15 years ago.

4. RESEARCH AND DEVELOPMENT (R&D) INCENTIVES

One objective of investment incentives tends to be the pursuit of technology transfer. Singapore and Malaysia, for example, have developed an incentives' program geared at research and development efforts and technological project. The tax benefits normally granted are: tax credit for R&D spending and employee training, deduction of payments for technical assistance and patents' use authorizations, and exemption from taxes on imports of machinery, equipment and instruments.

5. INCENTIVES AND TAX BENEFITS

In addition to the tax incentive with the aim of promoting a change in companies' behavior, tax systems also serve the purpose of providing assistance to taxpayers.

Every incentive implies a benefit, but not every benefit entails an incentive, even if both result in revenue losses, to the extent their outcomes are intentional measures to render financial assistance to taxpayers by means of a reduction in their tax liability. Incentives may be defined as benefits aimed at modifying economic agents' behavior equation with the ultimate purpose of increasing investment in certain sectors or regions, or obtain an increase in exports, etc. On the other hand, a benefit such as health expenses deductible from income tax, for example, is certainly not an incentive (to make people ill), but a form of financial support (indirect) for taxpayers.

6. TAX EXPENDITURES

The tax expenditures concept was used for the first time in 1967 by Stanley Surrey [Pathways to Tax Reform, 1973], at the time he was Assistant Secretary for Tax Policy at the Treasury Department of the United States. Surrey pointed out that deductions, exemptions and other benefits granted on income tax were not part of the inherent structure in the tax and were truly, government spending made through the tax system in lieu of direct spending, through budget items. That is why he called them Tax Expenditures.

This approach to fiscal benefits, such as expenditures compared to budget spending but granted through the tax system, was a novelty. The analysis of the tax expenditure stems from the principle that any tax is made up by two components:

(i) that which covers all the legal provisions that form the regulatory structure of a tax;

(ii) the special provisions that represent a deviation from the regulatory structure.

The former are indispensable in the definition of the tax itself: taxable event, taxpayer, taxed goods, rate structure, payment conditions, jurisdiction, additional taxpayers' obligations, necessary by virtue of tax administration purposes, or international agreements.

Special provisions, on the other hand, are deviations from the regulatory structure as defined and seek to serve government objectives that are unrelated to taxes. These are fiscal benefits in the broad sense of the term; that is to say, they include tax incentives and benefits that are not incentives. Tax expenditures may derive from exclusions, exemptions, deductions, credits, preferential rates or deferment of the tax liability payment.

Tax expenditures may frequently not be efficient, effective or equitable, which is the reason why information on those features may help policymakers to make more informed decisions on their use.

6.1. Difficulties in Determining Tax Expenditures

Even on a theoretical basis, it is difficult to determine which provisions are deviations in the regulatory structure of a tax. It may be analyzed through situations about which different opinions may apply:

- If a VAT exemption is applied on the sale of certain food supplies, it may be considered that the tax is meant for advancement purposes, to the extent that these food supplies have a more relevant role in the family-shopping basket of lower-income individuals. But, in turn, if the exemption were considered a preferential treatment for certain individuals, it would become tax expenditure.

- On the other hand, it seems clearer that if the VAT rate structure evidences a general rate and a preferential rate, the latter applicable to products that make up the family shopping basket, it is the tax definition itself which sets forth this rate structure and therefore, the loss of revenue implied in not taxing basic food supplies at the general rate is not tax expenditure.

- There is frequently a disregard on the part of sub-national governments in their tax collection efforts, to the extent that federal government revenue sharing provides them with the necessary resources to operate. The basic tax structures of the taxes collected by said local governments are perfectly defined and there are no special provisions to the contrary. Then, should the loss of revenue described be deemed tax expenditure?

- Some time ago, indirect taxes' refunds paid by exporters in the production process of the good to be exported could be considered an exports' incentive and, therefore, the fiscal cost attached to this refund was tax expenditure. Nevertheless, after the consensus reached as to the fact that taxes cannot be exported, it is difficult to sustain the standing that it is tax expenditure.

- In the case of selective taxes since the tax by definition is only applied on certain items, loss of revenue for the ones excluded would not be deemed tax expenditure. Certain selective taxes, such as alcoholic beverages and cigarettes, are used as regulatory taxes; that is to say, regulations are introduced via the tax system instead of direct regulation. Therefore, any non-taxed transaction would probably represent an area that was not meant to be governed by regulations.

There are different methodologies to estimate tax expenditures. The loss of revenue method is an *ex post* manner to calculate the amount the government failed to collect based on the benefit. The method does not consider taxpayers' behavior reactions before the measure. Therefore, the tax expenditure for a tax credit is exactly the value thereof and for a deduction, its value times the marginal rate.

The revenue profit method is an *ex ante* form of calculation that considers the additional collection that would stem from the rejection of the legal provision that generates the tax expenditure. In this case, possible taxpayer's behavior reactions are considered, which calls for a good database and knowledge as to flexibilities (income, price and substitution). It is not an easy task.

The third methodology is that of equivalent expenditure, which attempts at estimating direct budget spending that would be required to render an equivalent taxpayer benefit or profit.

If determining and quantifying tax expenditures is theoretically difficult, it is even more so to make a comparison among countries. Tax regulations are determined differently in each country, and so are the deviations from the regulation, rendering international comparisons difficult (or rather, purposeless).

Therefore, any comparative analysis of the available measurements for tax expenditure must be very conservative. An additional problem arises in countries with a federal structure such as the Untied States of

America, Argentina and Brazil, to estimate the tax expenditure of sub-national governments –provinces and states, respectively-. In the majority of the countries of the world, including federal ones, tax expenditures' estimations are only available for the central or (federal) government.

Maybe a way of making comparisons and relative measurements of tax expenditures instead of looking at other countries may be to consider historical series within the country itself and/or making comparisons with other macroeconomic indicators such as public spending, fiscal deficit and collection.

6.2 Tax Expenditures' Strengths and Weaknesses

Among the positive aspects of implementing tax expenditures the following may be outlined: 1) promoting private sector participation in social and economic programs, where the government generally plays a leading role; 2) promoting the private decision process, delegating initiatives and choices to private players; and 3) reducing the government involvement need in the implementation of certain government spending programs.

The negative aspects are generally linked to inefficiencies, inefficacies and inequalities. They are frequently inefficient when they answer the interests of specific groups with sufficient political power and fail to generate additional investment. They are frequently ineffective since they lack the capacity to counter the underlying economic conditions or being annulled or mitigated by other tax provisions, domestic or external. They are unfair in general terms, whether because they benefit taxpayers' who pay that tax – and not all citizens- and also regressive since they change tax burdens, from the vertical as well as horizontal standpoint.

Other negative effects are, in practice, the "open" public spending programs, concealing the true size of the State, and the unnecessary complexity of tax systems, paving the way for opaque rules, elusion and evasion.

Maybe, one of the most serious negative impacts is the erosion in tax bases, with the resulting increase of taxes for non-beneficiaries of the "benefits" and/or hindrance in fiscal balance and macroeconomic stability.

6.3. Tax Expenditures' Reports or Budgets

These are reports that countries prepare for the purpose of fiscal transparency and the quest for the efficient allocation of government resources. Formats based on "patterns" are not available to file these reports. In general terms, they describe tax regulations, legal power to deviate from regulations; the grounds or rationale to enjoy the benefit; and the revenue loss estimates.

The classifications employed in these reports also vary, and depend on the availability of data and the policymakers' needs. In general, countries classify tax expenditures according to budget functions to facilitate comparison with direct spending. Productive sectors and regions are also frequently used, in addition to type of tax, beneficiaries and purpose. There are countries considering the tax expenditure estimation based on income decile of beneficiary taxpayers.

In the majority of the countries that draft said reports, a legal provision exists for that purpose, but some do it based on Parliament's sole interest in better evaluating government revenue decisions and spending. According to a World Bank study in [2004] based on data for 10 OECD countries, Canada, United Kingdom, and Netherlands do so without a legal provision. In Austria, Belgium, France, Germany, Netherlands and United States, they are documents attached to the budget, while in Australia, Canada and United Kingdom, they are separate documents.

As to the frequency, in eight out of the ten countries it is annual, only occasionally in Italy and biannual in Germany. The ten countries employ the revenue loss method, and only the United States additionally uses the equivalent expenditure method.

The reports from Austria and Italy are the only ones to consider the national and local government levels. The rest only take into account the central or federal government level. As to the taxes considered, the Tax Expenditures reports from these 10 countries include the main sources of revenue, which entail, among others, income tax and VAT, except for the USA.

6.4. Tax Expenditures in the USA

A recent study from the US Government Accountability Office GAO [2005] allows us to perform a very good assessment of tax expenditures' evolution in the last 30 years, in value, number and compared to income, expenditures and GDP.

The estimations of tax expenditures in the USA are carried out by the Office of Tax Analysis of the US Department of the Treasury as well as the US Congress Joint Committee on Taxation. The estimations from both institutions differ, but are not significant overall, in the number of Tax Expenditures as well as regarding their value. They are considered income taxes for individuals and corporations, as well as inheritance taxes and social security contributions. The great majority of tax expenditures are included in Income Tax, especially on individuals.

Treasury estimations are incorporated on an annual basis as supplementary information to the Federal Budget. The estimation of revenue loss is performed separately for each one of the Tax Expenditures individually, comparing the income obtained according to current legislation and that which would apply in case the provision was not in effect, assuming that all the other provisions in the tax code would remain constant and the taxpayer's behavior would not change. Since the estimation does not consider taxpayers' behavior-based reactions (flexibilities, for example), it does not necessarily represent the revenue amount that the administration would collect in case the provision was rejected.

In addition to the estimated revenue loss, the Treasury estimates tax expenditures based on equivalent expenditures, in other words, the amount of budget spending required in case the government decided to provide the taxpayer the same amount of net revenue (after tax) that it receives according to tax expenditures. This form of estimation, in general terms, produces higher values than those for revenue loss. The GAO study indicated that the estimated tax expenditures based on equivalent-expenditures have remained reasonably stable around 7.5% of GDP in the last 10 years.

The disaggregated and independent form of estimation of each tax-expenditure may lead to arguments as to the overall amount. This is a methodological problem of tax expenditures' measurement that all countries are faced with, and mandate a conservative interpretation of the results added, since it does not consider the interactions that may

exist according to the different legal provisions that generate tax expenditures. That is why neither the Treasury nor the JCT make an aggregation and do not submit the total amount of the different tax expenditures.

The United States have been performing systematic estimations of tax expenditures since 1974, and since then and until 2004, their number has increased from 67 to 146, with some that expired or were rejected and others that were created. In that same period, the total revenue loss has increased from US$240 billion to US$730 billion in constant dollars.

The 14 main tax expenditures accounted for 75% of the federal revenue loss in 2004. The greatest amount of tax expenditures is relative to benefits to individuals (89%). The main areas that benefit are housing (22%), health (14%) and pensions (13.1%).

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Case study

TOPIC 1.2

MEASUREMENT AND CONTROL OF EROSION OF THE TAX BASES (TAX EXPENSES AND TAX EVASION)

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CONTENTS: Summary.- 1. Introduction.- 2. Measurement of Tax Expenditure.- 2.1. Why measure tax expenditure?- 2.2. Definition of tax expenditure implemented in Chile.- 2.3. Methodology.- 2.4. Outcomes of TE estimations.- 3. Tax Evasion Estimations.- 3.1 The importance of measuring evasion.- 3.2 The theoretical potential method based on national accounts.- 3.3. Budget survey methods.- 3.4. Point sampling method.- 3.5. Tax information reconciliation methods.- Bibliography.

SUMMARY

The aim of this report is to explain the Chilean experience as to measurement of potential collection. For that purpose, a separate approach is made to measurement of tax expenditure and measurement of tax evasion. In both cases, we begin by discussing the importance of measuring both aspects, which goes beyond assessing potential collection improvements. Then, a description of the methodologies employed in each case is provided, and outcomes are presented to illustrate the point.

As to tax expenditure, it is worth highlighting that the first measurement in Chile dates back to 1999, as an independent effort by the Internal Revenue Service (SII, as per the Spanish acronym). Nevertheless, only in 2002 did the annual estimation become part of the Public Finance Report that is attached to the General National Budget Bill delivered to the Honorable Parliament.

As to the methodological aspect to measure tax expenditure, an *ex post* measurement is applied; in other words, based on effective information for a period elapsed but using the assumption of a change of behavior in taxpayers: the assumption of overall ongoing expenditure. A cash flow assessment is applied, analogous to that used in the Budget drafting process.

The main sources of information to conduct the estimations are the Returns filed by taxpayers and withholding agents, tax revenue statistics, national accounts and public information of the Financial Statements of open-ended Corporations. The types of methodologies employed differ, the most relevant ones being: simulations based on Income Tax Returns; global projections based on simulations conducted on a group of companies; estimations based on aggregate data or tax revenue statistics; and VAT-exemption estimation models based on the Input-Output Matrix.

With regards to tax evasion, the SII started to conduct annual VAT evasion measurements in the early ‘90s, through the Theoretical Potential Method based on National Accounts. Concurrently, alternative methodologies were developed, mainly to measure VAT and Income Tax evasion.

The Theoretical Potential Method based on National Accounts is useful to measure flat rate tax evasion with a tax base in line with a macroeconomic aggregate. Such is the case of VAT and Corporate Income Tax. The main advantages of the method are that it enables to measure evasion on an annual basis, facilitating the evolution analysis, and it is relatively simple and low cost. The restrictions relate to the reliability of the source employed to quantify potential collection, in this case National Accounts.

An indicator for VAT evasion, quite simpler than the above-mentioned method, is the Final Productivity-Consumption Index, defined as the quotient between VAT collection, expressed as a percentage of end

household consumption and the VAT rate. This indicator is useful to assess evolution of VAT evasion, especially when access to sufficient information from the National Accounts System is not available.

Another means to estimate potential collection of taxes is by family budget surveys or other similar tools. These methods are especially useful to estimate evasion of individual income taxes, given the progressive nature thereof. In Chile, the National Socioeconomic Description Survey (CASEN, as per the Spanish acronym) is employed.

In the area of sample surveys, Chile has measured VAT evasion based on under-filing of sales to end consumers, using the so-called point audits. A random sample of companies is subjected to a point audit during one business day. During that time, perfect compliance with tax obligations shall be observed, specifically issuance and recording of sales invoices. Then, in order to obtain an evasion measure, a comparison is determined as to the sales recorded in the audit period with those recorded in previous periods under similar conditions.

Finally, a method has been developed to measure VAT evasion based on false invoice entry and other credit increases, without the respective debit entry. This method called Tax Information Reconciliation basically consists of comparing the credits filed by VAT taxpayers with the debits from intermediate sales, including Imports' VAT in this process. Once a number of adjustments have been performed, the positive difference between both measurements may be attributed to evasion.

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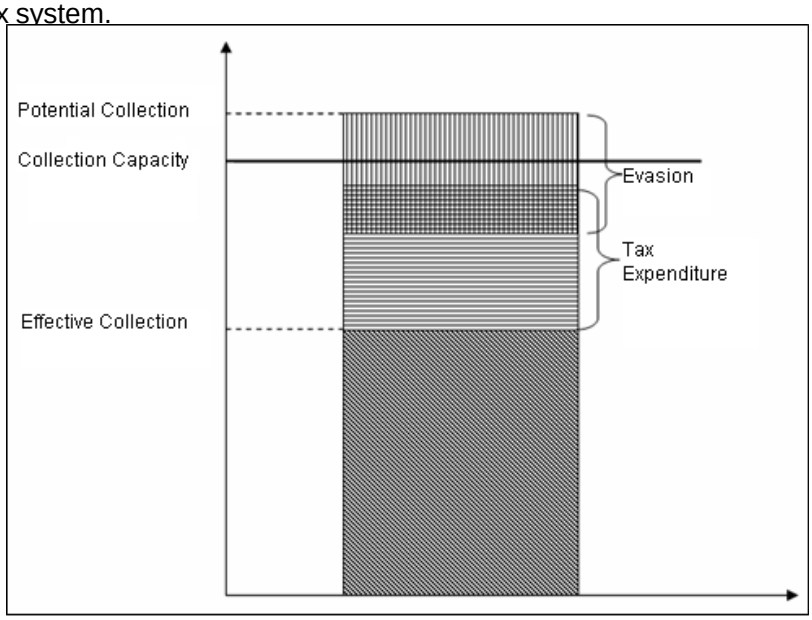
1. INTRODUCTION

For the purpose of this presentation, we shall understand by potential collection in a tax system the collection that would be obtained with one hundred percent tax compliance and without considering exceptions to general tax regulations. Thus, we assume that, as shown in the chart hereunder, the gap between potential collection and effective collection represents tax expenditure and tax evasion. The chart also indicates that the tax expenditure share overlaps with evasion, which shows that if there were no tax expenditure, a share of that larger collection amount would be evaded; and on the other hand, it also reflects that evasion is partly originated by the existence of tax expenditure.

In general terms, it is not possible to expect one hundred percent of successful potential collection. In fact, the marginal collection cost increases as evasion drops, which makes collection efficient only until said cost equals marginal collection. Also, from the standpoint of tax expenditure, even if some are true exceptions to the general regulations, in effect, it may occur that annulment thereof may not be socially accepted. Therefore, we may refer to “collection capacity” as the maximum feasible collection that might be obtained efficiently in a tax system.



If measuring potential collection is deemed a complex task, even more complex is measuring collection capacity. Nevertheless, it is good to have a clear understanding of this difference, at least from a conceptual standpoint. In the face of a scenario of insufficient collection, should there be a gap between effective collection and collection capacity, the most appropriate tools to increase revenue in terms of efficiency and fairness would be countering evasion and eliminating exemptions. On the other hand, when effective collection reaches collection capacity, the tools shall be those aimed at increasing potential collection, such as rate increases or the incorporation of new taxes.

The purpose of this presentation is to present the Chilean experience vis-à-vis measurement of potential collection. To that end, different approaches are provided for measuring tax expenditure and tax

evasion. In both cases, we begin by discussing the relevance of measuring both indicators, which goes beyond assessing potential for collection increases. Subsequently, a description is made of the methodologies employed in each case and for illustration purposes, some of the outcomes are stated.

With regards to tax expenditure, it is worth highlighting that the first measurement in Chile dates back to 1999, as part of a project conducted by the Department of Studies of the Internal Revenue Service (SII, as per the Spanish acronym), whose objectives were, in addition to measuring the collection effort arising from special tax treatments, to design the methodologies that enable the development of the annual estimations and identify the information requirements with a view to improving the quality thereof. Beginning in 2002, the annual estimation has been included in the Public Financial Report attached to the General National Budget Bill and submitted to the Honorable Parliament.

As to evasion measurements, the first studies were conducted in the eighties. Nevertheless, it was only in the early nineties that the SII started undertaking annual VAT evasion measurements, through the Theoretical Potential Method based on National Accounts. At the same time, alternative methods were developed mainly to measure VAT and Income Tax evasion, which have also been included in this report.

2. MEASUREMENT OF TAX EXPENDITURE

2.1 Why Measure Tax Expenditure?

Tax expenditure (TE) may be broadly understood as the loss of revenue stemming from exemptions or special tax regimes with the aim of favoring or advancing certain sectors, activities, regions or players of the economy. This entity is also called “tax waiver” since the Revenue Service waives, either partially or completely, the enforcement of the overall tax system, serving an ultimate objective of economic or social policy. The concept of TE thus arises with a view to defining a parallel between direct tax expenditure according to government budget performance and this indirect expenditure that stems from applying tax exemptions.

Regarding the measurement of TE, we must point out that this is indeed a complex task – and therefore frequently postponed in developing economies – although it is an extremely relevant one. Of course, the

measurement of TE entails a vital principle – that of fiscal transparency. In general, the most visible fiscal action – direct budget performance — is under ongoing discussion and analysis. The Development and maintenance of public budget systematic statistics enable this. Monitoring of tax incentives, on the other hand, tends to be hurdled by the lack of information. This is a first ground to measure TE, contributing to the transparency of governmental economic and social policies. There is also a consideration of political economy, since the aim is to explain which objectives are being pursued and who are the beneficiaries of non-budgetary fiscal actions.

Secondly, defining a measure of TE also enables a performance assessment of the tax system and guiding the administration thereof. Tax systems with more special regimes tend to feature higher degrees of tax complexity and more room for evasion and avoidance. Therefore, the measure of TE may illustrate performance as well as weak spots in a tax system.

Thirdly, in the context of tax reforms where the scope of action to include new taxes or greater tax rates becomes increasingly limited, relying on a TE measurement may be valuable, since the elimination of tax exemptions emerges as a new source of government revenue.

2.2 Definition of Tax Expenditure Implemented in Chile.

A given tax treatment shall be deemed TE to the extent it entails a departure from regular tax treatment and favors, promotes or stimulates a sector or player in the economy. Therefore, the starting point to measure TE is to define what is understood by regular tax system, which is obviously not free from subjectivity.

Following is a description of the regulation applicable in Chile for Income Tax as well as VAT, from which the TEs to be estimated arise. It is worth pointing out that the estimation of TE is limited to these two taxes, since they are the most relevant in the Chilean tax system and account for the largest number of exemptions in the system. In the case of VAT, the TE measurement concerns the general tax made up by VAT on domestic transactions, VAT on imports and the tax refund system. Therefore, excluded from the measurement are other additional rates to VAT or taxes on specific products.

2.2.1 Income Tax.

The Income Tax regulation foresees the following features:

- Definition of income in the terms defined by the Income Tax Act.
- Taxpayers are natural persons.
- The rates and brackets from the regulation are provided for in the Income Tax Act.
- The taxable party is the individual.
- The taxable period is the calendar year.
- The small taxpayers' regimes and simplified accounting are considered part of the standard.
- The Single Extraordinary Capital Gains Tax is considered applicable.

A detailed explanation of each one of these attributes is set forth hereunder.

- Definition of Income

In the case of Income Tax, the taxable base is considered the definition of income contained in the Income Tax Act itself, that is to say, as "the income that accounts for profits or benefits yielded by a thing or activity and all the benefits, profits and equity increases earned or accrued, whatever their nature, origin or denomination." By applying this definition, savings incentives such as those defined in Article 57 bis shall be treated as TE. Also considered TE is the deduction of social security contributions from the Second-Tier Single tax base and the tax exemption that benefits pension savings. Likewise, in the case of Corporate income tax, TE is understood as the application of a Global Supplementary tax on a realized base instead of an accrued base.

- Taxpayers are Natural Persons

A fundamental principle on which the Chilean Income Tax is based is that the taxable individuals shall be, ultimately, natural persons; taxes paid by corporations are only an advance on individual taxes. The regulation selected is in line with this principle. It implies that the First-Tier credit, which prevents double taxation of corporate profits, is not a TE.

– Income Tax Rate and Brackets

The First-Tier tax rate and the individual tax rates' scale, in agreement with their respective application, are considered part of the regulation. Equal consideration applies to the single tax rate applying on extraordinary capital gains.

– Taxable Party

The taxable party is considered to be the individual, in agreement with current legislation.

– Taxable Period.

The regular taxable periods considered are those set forth by current legislation. That is to say, the calendar year for First-Tier taxes and Global Supplementary tax, and the calendar month for the single Second -Tier tax.

– Special Regime for Small Taxpayers

Article 22 of the Income Tax Act sets forth five special regimes for "small taxpayers' (small scale miners, newsstand owners, shop owners, small scale repair shops and small scale fishermen). Each one of them applies as a single tax. These regimes are considered provided by regulations, since their ultimate objectives is to facilitate tax compliance by individuals without sufficient capacity, economic as well as intellectual, to keep complete accounting records. In effect, it is not clear whether the tax they must pay is greater or smaller than the one they would pay under the normal regime.

Equal criterion applies to the simplified accounting regime to which taxpayers who exploit real estate and agricultural real estate governed by the Forestry Legislation in effect adhere.

The taxable income regime is not considered applicable and neither withdrawal-based taxes (Article 14 bis), since both generate effective tax relief for those who enroll in them. In fact, it has been determined that taxable income equals, in average, the third part of actual income. On the other hand, the withdrawal-based tax regime releases retained earnings of the First Category tax.

– First- Tier Single Tax on Extraordinary Capital Gains

In the case of extraordinary capital gains, it has been considered that the normal treatment for this type of income is embodied in the First- Tier Single Tax. To this end, the applicable definitions considered are those foreseen in the Income Tax Act, relative to the frequency of operations and taxpayers' economic upturn.

2.2.2 Value Added Tax.

The Standard definition of VAT is that applicable to consumers, which imposes a single rate on all domestic sales and imports of goods and services. Zero rate for exports are considered standard, since this exemption is not geared at favoring a specific sector in the economy, but to avoid double taxation of exported products. The latter implies considering the applicability of all the exemptions on exports as well as the mechanism in place for VAT refunds to exporters, as set forth by law.

There are a number of other specific exemptions in the tax that are considered standard, since they are aligned with internationally adopted conventions or exclusions. This are the imports from Foreign Affairs' offices, international agencies, expatriate Chilean officials or personal property of immigrants, institutions exempted based on international treaties subscribed by the country; assets entered in the luggage of travelers according to certain limits and conditions; personal property and vehicles entered by passengers or visitors during their stay and the transitory entry of assets into the country. Additionally, the exemption for entry of works of art by Chilean artists is deemed applicable.

On the other hand, a feature of the Chilean VAT, which may be a matter for discussion if considered included by regulations, is the treatment of remittances. In Chile, remittances may be returned only if they originated from the acquisition of fixed assets and after a six-month term. In theory, consumption tax should enable returns of remittances, whatever their origin, otherwise there is a financial cost for the company that bear them, which end up being transferred to the end consumer, thus altering the neutral nature of the tax. By virtue of the aforementioned, the decision was made to consider the mechanism included in the VAT standard.

2.3 Methodology.

General Assumptions:

An ex-post measurement is employed, that is to say, based on effective information for an elapsed period, but applying the assumption of a change of taxpayers' behavior: the total ongoing expenditure assumption. Based on the latter, the elimination of an exemption implies less disposable income for taxpayers and therefore less spending capacity. Thus, if spending capacity drops, VAT collection drops, which partially mitigates the gross effect of eliminating the exemption. Certainly, eliminating an exemption may affect other decisions by economic players that are not addressed herein; as neither have we addressed changes of behavior in tax administrations or the evasion rate. In spite of being a simple assumption, it enables a better approach to the effective TE that would stem from the elimination of an exemption.

The TE figure of year t is a measure of the greater collection to be had in year t should a given exemption not be in effect. The measurement is conducted on an isolated basis, that is to say, assuming that the other exemptions remain unaltered. It is worth underscoring this assumption, since many exemptions have joint effects, which entails that the aggregate TE is not equal to the sum of the individual TEs. The report includes the estimation of the aggregate TE for Income Tax and for VAT, and the joint related effects are considered individually.

Finally, a cash flow assessment was decided, analogous to that employed in the Budget drafting process. When the exemption is linked to a tax that requires to be filed on a monthly basis or a withholding tax, the TE is related to the respective month (for example, in the case of VAT, interim monthly payments and the Single Second-Tier tax). When the exemption is linked to a tax that must be filed annually, the TE is linked to the respective fiscal year (for example, in the case of the Global Supplementary Tax).

Source of Information:

The following are the main sources of information that are the basis for estimations: individual income tax returns, aggregate data for income tax returns, third party returns, monthly VAT returns, Treasury Tax Revenue reports, financial reports from Bills of the Budget Office, input-output matrix of the Central Bank, financial statements of Open-ended corporations (FECUs, as per the Spanish acronym), National Statistics

Institute (INE, as per the Spanish Acronym) survey of household budget, statistics from the Pension Funds Administrators' Regulatory Agency (AFPs, as per the Spanish acronym), statistics from the Higher Council of Education and other specific studies.

Types of Methodologies Employed:

Tax expenditures may assume different forms, such as: exemptions, base deductions, tax claims, deferrals, reduced rates or special regimes. In turn, the degree of available information for every item to be estimated varies in quantity and quality. Therefore, there is not a unique methodology to be employed in the estimation of TE, but an array of methodologies, each one applicable to a group of exemptions. The most relevant are described hereunder:

- Simulations

Simulations entail reformulating the tax returns for each taxpayer, adding the exempted income to their tax base or the deduction under analysis, or reversing the effect of deferrals. It is used on the Income Tax for special regimes, for the majority of exemptions and deductions, and for deferrals of individual taxes. Simulations obviously require that the exempted amounts, to be deducted or deferred, be reported by taxpayers to Tax Administrations in their tax returns or by third parties, via returns or other reliable means. In special regimes, it was necessary, additionally, to estimate the effective taxable income from tax, procurement and payroll information.

- Universe-based projection according to simulations performed on a group of companies for which sufficient information is available.

This methodology applies for the estimation of the TE related to corporate tax deferrals, such as accelerated depreciation. In such cases, there is not sufficient information on the Tax Returns to support simulations; therefore, resorting to an external and public source is required, such as financial statements of the open-ended corporations. For these companies, the TE is calculated from fluctuations in the deferred taxes accounts, the composition of which must be detailed in the notes to the financial statements, as required by the regulatory agency. Thereafter, estimations performed for this group of companies are expanded to the universe on a pro rata basis against the asset volume.

– Estimation based on aggregate data or tax collection statistics.

The most widely used estimation is that of TEs related to tax claims. The basic data is directly gathered from aggregate statistics of tax returns or tax collection statistics, in cases in which the accounting plan gathers the amounts charged for these claims.

– VAT Exemption Estimation Model

In Chile, VAT returns forms lack sufficient information on exempt activities, since filing VAT is not mandatory for individuals who conduct this type of activities exclusively. Moreover, based on the VAT principles, in order to assess the effect of an exemption on revenue collection, not only is information required from selling parties, but also from purchasing parties, which is information difficult to gather from returns. Therefore, the TE is calculated from the majority of VAT exemptions based on a non-deductible VAT model according to the Central Bank Input-Output Matrix. It applies on the inter-sector sales and purchases of the 75 products that make up the Input-Output Matrix. The TE for each exemption is estimated by recalculating the non-deductible VAT of the model. The result is spread across the system overall, employing the ratio between overall collection based on the model and overall effective collection of the tax for the year of the calculation.

– Financial Report in Recently Passed Laws

In certain cases of exemptions that were recently approved, the estimation of the tax cost from the financial report of the respective Bill is applied.

– Other Specific Methodologies

Finally, specific methods are used in the case of measurements of TEs related to Real Estate Income, tax-free areas, pension fund investment yields and certain specific VAT exemptions.

2.4 Outcomes of TE Estimations.

Following is a summary with the most relevant outcomes of TE projections for 2005. Chart 1 introduces the TE, in millions of pesos and as a percentage of GDP, grouped by type of exemption. The overall TE amount projection for 2006 accounts for 3.57% of GDP.

Chart 1
Tax Expenditure 2006

	Millions of $	% of GDP
Income Tax	**2,025,907**	**2.98%**
Special Regimes	27,520	0.04%
Exemptions	208,765	0.31%
Deductions	136,919	0.20%
Tax Claims	149,625	0.22%
Tax Deferrals	1,475,256	2.17%
Rate Reductions	7,594	0.01%
VAT	**404,314**	**0.59%**
Exemptions and Non-taxed Activities	207,640	0.31%
Claims	194,592	0.29%
Tax Deferrals	2,083	0.00%
TOTAL	**2,430,221**	**3.57%**

Source: Office of Studies, Internal Revenue Service (August, 2005).

Chart 2 shows the projection, differentiating tax expenditures by sector or activity they seek to benefit. It may be observed that the largest number of TE in Chile is linked to savings and investments' incentives.

Chart 2
Tax Expenditure 2006
Organized by Sector or Beneficiary Activity

Sector / Objective	**Millions of $**	**%GDP**	**%TOTAL**
Savings-Investment	1,588,584	2.33%	65.4%
Real Estate	341,648	0.50%	14.1%
Education	193,094	0.28%	7.9%
Health	191,292	0.28%	7.9%
Regional	57,606	0.08%	2.4%
Advancement of SMEs	43,072	0.06%	1.8%
Transportation	35,723	0.05%	1.5%
Insurance	13,607	0.02%	0.6%
Exporters	1,792	0.00%	0.1%
Other	75,620	0.11%	3.11%
Joint Effects	-111,818	-0.16%	-4.60%
TOTAL	**2,430,221**	**3.57%**	**100.00%**

Source: Office of Studies, Internal Revenue Service (August, 2005).

Chart 3 hereunder shows tax expenditure for 2004-2006 aggregated by type of tax.

Chart 3
Tax Expenditure 2004-2006

	2004		2005		2006	
	Millions of US$[1]	% of GDP	Millions of US$[1]	% of GDP	Millions of US$[1]	% of GDP
(I) Income Tax	2,660	2.83%	3,161	3.07%	3,324	2.98%
A) Corporations	756	0.80%	970	0.94%	1,062	0.95%
B) Individuals	1,904	2.02%	2,190	2.13%	2,261	2.03%
(II) VAT	588	0.62%	611	0.59%	663	0.59%
Total	3,248	3.45%	3,772	3.66%	3,987	3.57%

Note:1 Considering the 609.53 ($/US$) exchange rate, as the average for 2004.
Source: Office of Studies, Internal Revenue Service (August, 2005).

Finally, Chart 4 features the 10 most relevant tax expenditure items (organized according to financial impact), and presents the projection of resources related to each one of them in 2006, in millions of Dollars (based on the average exchange rate for 2004), as well as percentage of GDP.

Chart 4
Tax Expenditure 2006
Most Relevant Items

Tax Expenditure Item	Category	Sector	Million US$[1]	% of GDP
(1) Retained Corporate Earnings	Income Tax, Individuals, Deferrals	Savings-Investment	929	0.83%
(2) Treatment of Earnings from Pension Funds System	Income Tax, Individuals, Deferrals	Savings-Investment	619	0.55%
(3) Special Credit for Housing Projects	VAT, Credits	Real Estate	319	0.29%
(4) Accelerated Depreciation	Income Tax, Corporations, Deferrals	Savings-Investment	269	0.24%
(5) Other Temporary Differences	Income Tax, Corporations, Deferrals	Savings-Investment	239	0.21%
(6) Profits from Housing Leases Registered in DFL2	Income Tax, Individuals, Exemptions	Real Estate	185	0.17%
(7) VAT Exemption for Health Services	VAT, Exemptions	Health	185	0.17%
(8) Withdrawals Reinvested within 20 Days	Income Tax, Individuals, Deferrals	Savings-Investment	164	0.15%
(9) VAT Exemption for Educational Institutions	VAT, Exemptions	Education	152	0.14%
(10) Leasing Installments	Income Tax, Corporations, Deferrals	Savings-Investment	149	0.13%

Note:1 Considering the 609.53 ($/US$) exchange rate, as the average for 2004.
Source: Office of Studies, Internal Revenue Service (August, 2005).

3. TAX EVASION ESTIMATIONS

3.1 The Importance of Measuring Evasion.

Relying on information regarding the tax evasion amounts is relevant for a number of reasons. Firstly, it enables the Tax Administration to better focus their oversight efforts. If the Tax Administration counted on evasion estimations by tax, evasion mechanisms, geographical area or economic sector, it would better allocate resources for oversight, thus improving the effectiveness of their actions. Secondly, it enables to measure the outcomes of oversight plans and carry out modifications as required. Finally, tax evasion may be employed, with certain limitations, as a measure of efficacy for Tax Administrations. Should the purpose of the efforts of the Tax Administration be to improve tax compliance, then the appropriate performance indicator is the rate of compliance: other factors being equal, the higher the rate of compliance, the better the Tax Administration's performance.

In the aforementioned context it is vital to rely on figures as to levels of tax evasion in the economies. But, estimating evasion is not an easy task, since there are very few countries that perform measurements on a regular basis and even fewer that disclose their results. On occasions, the estimations on the size of the informal economy are used as an approach to tax evasion estimations, presumably based on the more formal development of said methodologies[1] and the fact they are relatively easy to apply. Nevertheless, not all informal activities induce tax evasion. For example, household employment is an informal activity but does not affect taxes. Likewise, salaries earned by workers in the informal economy do not entail tax evasion if income is foreseen in the exemptions bracket.

As to the methodologies, whose immediate purpose is the measurement of tax evasion, there are two broadly implemented approaches. The first one is based on the "theoretical potential" and relies on related variables to estimate the collection to be obtained if all taxpayers paid their taxes, which may be compared to the effective collection to determine evasion. The second approach is of a sampling nature and employs the tax administration capacities to detect non-compliance, overseeing a cross-section of taxpayers and then extending the outcomes to their universe.

[1] The most widely used methodology for these purposes is that of "money demand", which assumes that informal transactions are materialized through cash payments. Therefore, an increase in informal transactions should be reflected in an increased demand for money.

In the subsequent sections, a number of methodologies to estimate evasion which have been applied in Chile are presented, which feature both approaches referred to above; some of the outcomes are presented and the strengths and weaknesses are mentioned respectively.

3.2 The Theoretical Potential Method Based on National Accounts.

In general terms, this method consists of estimating the potential collection of a tax – that is to say, the one obtainable should evasion be zero – from an independent source of information, or relatively independent, such as National Accounts (hereinafter NA). Subsequently, this potential collection is compared with the actual or effective collection, and the resulting gap is attributable to tax evasion.

Application on VAT

VAT is a tax that applies to most transactions of goods and services in the economy. Nevertheless, given the fact that it operates on the basis of the system of debits and credits, these transactions do not generate net tax revenue except when they apply on end consumers. Thus, the theoretical basis for VAT may be aligned with macroeconomic aggregates such as government consumption expenditures.

According to this method, known as non-deductible VAT, the tax base is calculated from household end-consumption, on which a discount of the exempted consumption percentage applies and to which we must add the intermediate taxed consumption component and taxed investment from exempt sectors, since the latter become transactions with non-deductible VAT. We must also add VAT on consumption from non-residents and certain exports that may eventually be taxed with VAT. Finally, the effective VAT collection is subtracted, since it is part of household end-consumption, thus obtaining the theoretical basis of the tax (refer to Chart 1a).

Applying the tax rate to this theoretical basis, we obtain the theoretical VAT collection, which is compared to the effective VAT collection, that is, the collection stemming from taxpayers' returns. The gap between both values, the theoretical and effective one, is considered evasion.

One of the difficulties in applying this method lies on the calculation of the exempt end-consumption and the expenses from exempt corporations. In general terms, these variables may be calculated with greater accuracy for the year in which an Input-Output Matrix is available, while for subsequent years, they are updated by applying growth rates from gross production value, intermediate consumption or GDP of the exempted sectors, depending on which is the best information available.

	Chart 1a. **Theoretical VAT Tax Base Estimation according to the Non-deductible VAT Method**
+	End Household Consumption and IPSFL
-	Exempt End-Consumption
	End-Consumption from Exempt Sectors
	Imports from Tax Free Areas
	Consumption from Residents in Foreign Jurisdictions
	Others (agricultural products for personal consumption, gratuities, etc.)
=	Assessed Final Consumption
+	Allocated Expenses from Exempted Companies
	Assessed Intermediate Consumption for Exempt Production Activities
	Assessed Investment for Exempt Production Activities
+	Assessed Consumption for Non-Resident Foreign Citizens
+	Assessed Exports
-	Net VAT Collections
=	Theoretical Tax Base

Chile has been applying this method since the early '90s. The following chart explains the estimated outcomes for the 1996-2004 period.

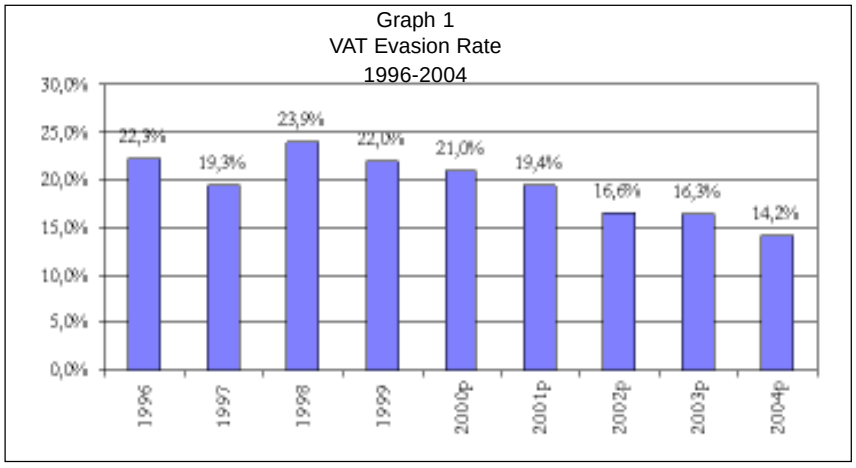
Chart 5
VAT Estimated Evasion– Based on Input-Output Matrix 1996
(Figures in Billion $ Annually)

	1996	**1997**	**1998**	**1999**	**2000[1]**	**2001[1]**	**2002[1]**	**2003[1]**	**2004[1]**
Theoretical Collection	2,995	3,248	3,561	3,580	3,905	4,224	4,436	4,824	5,344
Effective Collection	2,329	2,620	2,711	2,793	3,087	3,405	3,700	4,039	4,587
Evasion Amount	667	628	850	787	819	819	736	785	757
Evasion Rate	**22.3%**	**19.3%**	**23.9%**	**22.0%**	**21.0%**	**19.4%**	**16.6%**	**16.3%**	**14.2%**

Note:1 Temporary Figure
Source: SII Office of Studies, on the basis of information provided by the Central Bank.

From the previous estimation we may observe a relevant drop in VAT non-compliance since 1996, when it amounted to 22.3%, up to 2004 when the same indicator according to projections was calculated at approximately 14%. In any case, it must be considered that the estimation for the last years of the study is marked by the “temporary” nature of the source information from national accounts. Therefore, tax evasion figures are subject to review insofar as the national accounts are adjusted by the issuing agency.

Graph 1
VAT Evasion Rate
1996-2004



Depending on the degree of disaggregation in which the NAs are published, it is possible to obtain evasion estimations by economic sectors. In this case, the tax base shall be estimated as the difference between assessed sales, calculated from “Gross Production Value”, and the procurements that entail credits, calculated from “Intermediate Purchases” and “Investment”. In many countries, the information available is sufficiently disaggregated from the Input-Output Matrix, which is published every ten years approximately.

VAT Productivity Index as the Indicator of Evasion Rate Evolution

The VAT Productivity index is defined as the quotient between VAT collections, expressed as a percentage of GDP, and the VAT rate. High values in this index are attributed to high tax yield, originating from good tax compliance and a broad tax base.

A second form of defining this index is by expressing collection as a percentage of household end-consumption spending, which is deemed more appropriate, since this variable is better aligned with the VAT tax base. An index equal to one would be rendering VAT free from

exemptions and evasion. On the other hand, values close to zero would reflect high evasion rates or high percentage of tax-exempt consumption or both.

The following chart features the calculation of both indicators for Chile. If the productivity-GDP index is considered, it shows a relevant increase from 1996 to 2002, upon increasing from a base value of 100 to a maximum value of 107.1. In 2003 and 2004, nevertheless, the index shows a reduction to values of 105.4 and 101.6. The reason for this reduction is mostly found in the nominal GDP effect-price, which according to past records of national accounts, is grounded on a significant increase in prices of exported products that participate in the GDP. That is to say, the drop bears no relation with increases in evasion or VAT exemptions.

On the other hand, if the benchmark considered is the End Consumption, which should be the most adjusted variable with an aggregate tax base, productivity shows a more relevant increase throughout the period. Indeed, from a base value of 100 in 1996 it reaches almost 112 in 2004.

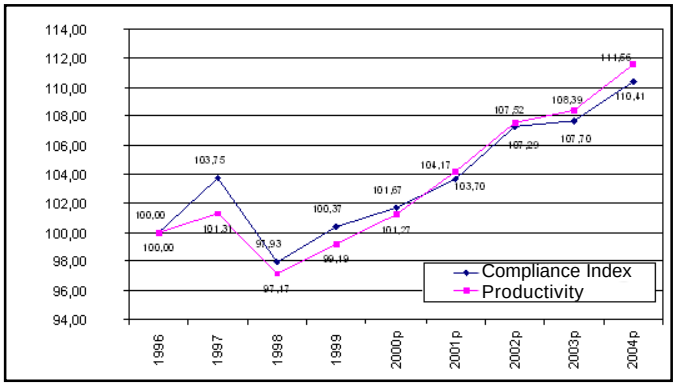
Chart 6
VAT Productivity Index – Based on Input-Output Matrix 1996
(Figures in Billion $ Annually)

	1996	**1997**	**1998**	**1999**	**2000[1]**	**2001[1]**	**2002[1]**	**2003[1]**	**2004[1]**
Effective Collection	2,329	2,620	2,711	2,793	3,087	3,405	3,700	4,039	4,587
% of GDP	7.5%	7.5%	7.4%	7.5%	7.6%	7.8%	8.0%	8.0%	8.0%
% of End Consumption	11.8%	11.9%	11.4%	11.7%	11.9%	12.3%	12.7%	12.9%	13.9%
Mandatory Rate	18%	18%	18%	18%	18%	18%	18%	18.25%[2m]	19%
Productivity-GDP:									
Index Value	0.414	0.419	0.412	0.418	0.423	0.434	0.444	0.436	0.421
Base Value 100=1996	100.00	101.22	99.53	100.90	102.05	104.91	107.12	105.35	101.64
Productivity-End Consumption:									
Index Value	0.654	0.662	0.635	0.649	0.662	0.681	0.703	0.709	0.729
Base Value 100=1996	100.00	101.31	97.17	99.19	101.27	104.17	107.52	108.39	111.56

Source: SII Office of Studies, on the basis of information provided by the Central Bank.
Note:
1 Temporary Figure
2 Average weighted rate by effective months in 2003 (18% rate for 9 months and 19% rate for the remaining 3 months).

Now, the productivity index should be consistent with the evasion rate, as inherent in its own definition. The productivity index may also be defined as the product between two variables: the aggregate tax base ratio against Consumption; and the rate of compliance.[1] Hereunder, Chart 2 simultaneously presents the series of the Productivity-Consumption Index and the series on the second material variable, VAT compliance. The latter has been taken to a base value of 100 in 1996 to facilitate comparison.

Graph 2
VAT Compliance and Productivity
(Base 100=1996)



[2] Indeed, if VAT effective collection is represented by *R*, the VAT mandatory rate by *t*, the theoretical tax base by *B*, and the tax evasion rate by *and*; then R is expressed as follows:

$$R = B*t*(1-and)$$

If divided by End Consumption (EC) and by rate *t*, we then obtain:

$$\frac{(R/EC)}{t} = \frac{B}{EC} * (1-and)$$

The left term of the calculation above is the exact expression of the productivity index:

$$\text{P. Index.} = \frac{B}{EC} * (1-and)$$

The previous chart explains that the general upturn and downturn cycles of the Productivity Index-GDP correlate consistently with the variations experienced by the tax compliance index. To conclude, the Productivity-End Consumption Index is a good approach to measure the evolution of the VAT evasion rate, moreover when there is no sufficient information to perform measurements based on the theoretical potential method.

Application on Corporate Income Tax

A number of methodologies have been also developed to estimate non-compliance in Corporate Income Tax. In this case, the potential tax base is estimated from National Accounts Earned Surpluses, which call for proper correction to reflect the differences between this macroeconomic concept and the tax base for net income. Jorratt and Serra (2000) propose a method for Corporate Income Tax in Chile. In broad terms, the method consists of determining, firstly, the Theoretical Tax Assessment of corporations, subtracting an estimation of surpluses from non-assessed and non-taxed activities, the surpluses of companies subject to assessable income, and the losses from previous fiscal years- deductible for tax purposes- from the Earned Surpluses and adding the currency adjustment factor. Subsequently, the Theoretical Tax Base is defined excluding from the Theoretical Tax Assessment the tax losses of the year, this being the adjustment required for an adequate comparison with the Effective Tax Assessment that stems from returns filed. Finally, the Theoretical Collection is estimated as the Theoretical Tax Base times the tax rate, discounting the effective credits against the tax.

This brief description indicates that the Income Tax evasion estimation requires more adjustments than the VAT methods, firstly because the first one tends to entail more exceptions to the general rule, such as exemptions, special regimes, deferrals, etc. Likewise, the methodologies are less standard and must be developed according to specificities in the tax legislation of each country.

Restrictions in the Theoretical Potential Method based on National Accounts

In general terms, the limitations to the theoretical potential measurement method refer to the reliability of the source employed to quantify potential collection, in this case National Accounts. Among the most relevant, we may indicate the following:

- The use of accounting information from companies in certain economic sectors, or production surveys, which could feature evasion based on underestimation of the non-compliance calculations.
- The use of tax information to calculate the outcome for those sectors that are measured by activity and not asset types, such as the services and industrial sector.
- The changes in stock differences is an adjustment variable, to such an extent that if consumption has been underestimated so has evasion and the concealed consumption would be attributed to changes in stock.
- The annual estimation of National Accounts applies for certain sectors in which productivity is sustained, in other words, equal to the one estimated for the base. Should productivity increases occur, this would lead to the underestimation of the theoretical aggregated value, and therefore, evasion.

On the other hand, data from a number of sources of information are reconciled in the structure of National Accounts. If independent sources of information (for example, price or consumption surveys) enable to capture the actual number of transactions and their amounts, it is possible that estimations or underestimations are not such.

An additional limitation of this method is that estimations tend to be available with a one-year delay, and in general, allow for aggregated measurements. Therefore, it is not a very useful tool for decision-making as to the allocation of resources by Tax Administrations or the assessment of the performance of oversight programs.

To the aforementioned, we must add that the most recent National Accounts' figures are temporary and suffer adjustments with certain frequency. This aspect becomes relevant because the estimated tax evasion rate is quite sensitive to reviews of figures conducted by the Central Bank.

All in all, evasion studies based on the Theoretical Potential method are useful in determining orders of magnitude for evasion and control thereof, even when it is not possible to assess their reliability.

3.3 Budget Survey Methods.

Another method to estimate potential collection of taxes is based on family budget or other similar ones. These methods are particularly useful to estimate evasion of individual income taxes, given their progressive nature. Effectively, surveys enable to disaggregate the theoretical taxable bases in different income tax brackets, which is not possible with National Accounts.

In Chile, these methods have been applied to measure evasion of Second- Tier and Global Supplementary taxes, the source employed to estimate the theoretical base being the income reported in the National Socioeconomic Description Survey (CASEN, as per the Spanish acronym).

Firstly, the tax that each individual should have effectively paid is calculated, according to the rate scale applicable to his or her annual income. Then, collection is grouped according to income percentile and it is compared to the actual income filed in the Internal Revenue Service in line with the same income percentiles. The comparison is made by matching group of individuals and not individually, since individuals' identity is anonymous.

The method delivers for 2003 a 48% aggregated tax evasion rate for individual income taxes, less than the estimated 57% for 1996. The result by income deciles explains the growing evasion rate in line with income growth, which is consistent with the idea that evasion is more "profitable" for those who must pay higher tax rates.

The most relevant limitation in this method is the reliability of the answers by surveyed individuals. In the case of businesspeople, when asked about their monthly income, it is never clear whether the answer implies income before or after tax, or whether they are accrued profits or only withdrawals[3]. Also, and contrary to employees, businesspeople may lack an accurate idea of their monthly income.

[3] In Chile, individual income tax applies on earning withdrawals.

3.4 Point Sampling Method.

The most direct method to obtain non-compliance estimations for a given tax is by audits to a sample of taxpayers. The quality of the outcomes of this method depends on the depth and knowledge with which the audits are conducted, since they only enable to discover a portion of overall evasion. The non-compliance percentage detected in the audits shall depend, among other factors, of the experience of inspectors who conduct them. Also relevant is the cross-section of the sample. The main advantage of this approach is that if conducted appropriately, it enables to apply the overall set of statistical techniques to define levels of confidence and accuracy in the results, classify them by categories, validate hypotheses, etc. Unfortunately, the available statistics from audit results in the oversight departments are not generally useful to estimate evasion, since their selection bias is difficult to correct (the taxpayers audited are those deemed with a greater evasion potential). Therefore, estimating evasion annually through this method would be costly, since it would entail conducting audits on a specially designed sample of taxpayers.

The Point Sampling method typically employed to oversee or assume payment obligations for taxpayers,[4] entails the visit by an inspector to a company, who stays during a full business day to ensure absolute tax compliance. This method may also apply to measure under-filed sales, based on the following principle: a taxpaying company subject to an on-site audit shall be faced with the obligation of issuing invoices for their overall sales, recording them in the respective accounting records and later filing them on the VAT form. Therefore, in order to obtain a measure of evasion, the sales recorded during the audit period are compared to the sales recorded in previous periods under similar conditions.

In practice, the method entails the visit of an inspector to a company – without prior notice- to inform that a regular tax audit shall be conducted, the latter stays in the course of one business day. Nevertheless, the actual objective pursued with this method is that the presence of the inspector forces the company to issue all the end sales invoices and

[4] In Chile, contrary to the case in other countries, the point method is not a mechanism supported by legislation to assume a payment obligation and therefore is used only as a preliminary report to decide on in-depth oversight efforts.

that sales information be truthfully recorded from the invoice book to the sales book. This method was applied in Chile at the end of 1996 and mid-1997, considering a sample of approximately 300 companies from the universe of VAT taxpayers who issue sales invoices. SII inspectors designated one day for a point audit in each company, and also gathered daily sales information for weeks and months prior to the audit day.

The comparison between the audit day and previous similar days entailed certain hurdles in practice, on observing a strong variation in sales information. This problem was approached in the statistical processing of data developed by Engel, Galetovic and Raddatz [1998] to try to overcome these difficulties and obtain adequate evasion measures.

Outcomes indicate that taxpayers omit 24.6% of end consumer sales in their tax records, with a 4.8% standard deviation. In the assumption that these figures are consistent with the theoretical potential estimations, the conclusion is reached that 60% VAT evasion succeeds based on under-filing of end sales.

This experience is being currently repeated, once again with the support from the team of researchers of Universidad de Chile. Fieldwork was conducted throughout November and December 2005. A novelty incorporated this time is the use of an audit sample, with a view to comparing the sales from audited taxpayers during the point audit day to the audit sample sale on that same day.

3.5 Tax Information Reconciliation Methods.

On occasions, the tax information received by the Tax Administration from different sources enables the estimation of a number of tax non-compliance cases, by reconciling these data. The Internal Revenue Service of Chile developed methods of this type to measure VAT evasion based on the use of false invoices, which is briefly described hereunder.

In every intermediate transaction, understood as that occurring between two VAT taxpayers, the seller withholds the tax to the purchaser, which is assessed as the tax rate applicable on the transaction value. This amount also entails a tax debit for the seller and a tax credit for the purchaser. A similar situation occurs in the case of imports, where VAT

collected by Customs is in turn a tax credit for the purchaser. If we designate VAT credits as VC, imports' VAT as IV and VAT debits for intermediate transactions as VDIT, in aggregate terms, the following equality should apply:

$$VC = IV + VDIT \quad (1)$$

If VAT credits exceed the term on the right, we would be facing evasion based on false invoices. It must be pointed out that in this context the term "false invoice" refers to any increase in VAT credits without the matching debit entry. The evasion amount would simply be attributable to the difference between both terms of the equation. A useful indicator to assess the evolution of evasion would be rendered by the quotient between both terms of the equation, that is to say:

$$\text{Indicator} = VC / (VDIT + IV) \quad (2)$$

Just as in other countries that apply VAT, Chilean legislation allows for two other sales receipts: invoices and cash-sale slip. The former is used in intermediate transactions and supports the VAT credit. The latter is employed for end consumer sales or sales to non-VAT paying entities. The individual returns for VAT debits from each one of these two instruments enables the calculation of the VDIT for the VAT amounts reported on the invoices, subject to a number of adjustments mainly geared at excluding sales to exempt taxpayers, who normally request invoices in spite of not being entitled to a credit. On the other hand, VAT credits are filed individually on the monthly form, while VAT on imports may be gathered from government revenue records.

The following Chart states the results from estimations calculated for the period from 1998 to 2004. The results indicate that in 2004, evasion based on false invoices amounted to $114 billion (US$200 million approximately). Upon analyzing the indicator, we observe that this type of evasion was significantly reduced as to 1998, just as global VAT evasion, according to current estimations.

Likewise, assuming that these outcomes are consistent with those obtained with the National Accounts method, evasion based on false invoices reduced its share as to overall VAT from 38.5% in 1998 to 15.1% in 2004. On the same chart, the indicator for said global VAT rate has been also set forth, with significant consistency in the variations for both pieces of data.

Chart N° 7
Evasion based on False Invoices vs. Overall VAT Evasion based on National Accounts Methods
Millions of Pesos/Annually

Year	Evasion based on False Invoices (a)	Overall VAT Evasion NA Methods (b)	(a) / (b)	False Invoices Indicator	VAT Evasion Rate based on NA
1998	327,524	849,972	38.5%	1.037	23.9%
1999	236,124	786,692	30.0%	1.030	22.0%
2000	202,270	818,554	24.7%	1.020	21.0%
2001	220,520	818,702	26.9%	1.020	19.4%
2002	174,791	735,901	23.8%	1.015	16.6%
2003	149,397	784,973	19.0%	1.011	16.3%
2004	114,354	757,054	15.1%	1.007	14.2%

Source: SII Office of Studies.

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TOPIC 2

THE STRATEGIES FOR ACHIEVING POTENTIAL COLLECTION

Lecture

TOPIC 2

THE STRATEGIES FOR ACHIEVING POTENTIAL COLLECTION

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EXECUTIVE SUMMARY

In today's dynamic business environment, organizations are constantly searching for ways to become more effective. Tax administrations are not immune to this challenge, and a key measure of their effectiveness is how well they bridge the "collections gap;" that is, the difference between what could be collected and what is collected.

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[1] Speech given by Mister Guy Proulx, Assistant Commissioner of the Taxpayer Service and Debt Management Branch of the Canada Revenue Agency, on behalf Miss Gibson.

Like all tax administrations around the globe, the Canada Revenue Agency continuously strives to improve its operations in order to meet the challenges facing it. The Canada Revenue Agency's debt management arm, the Taxpayer Services and Debt Management Branch, has made significant improvements to its operations in recent years in order to become more effective. We have brought collections and compliance workloads together, re-engineered workflow processes to engage taxpayers earlier in the collections cycle, introduced risk management strategies to manage workloads more strategically, and eliminated geographic workload boundaries to make better use of limited resources.

Despite these improvements, the environment in which we operate continues to evolve and present new challenges. We are currently challenged by the continued growth and aging of our collections portfolio, the need to update our technology, the commitment to expand our core business activities, and our limited ability to obtain tax policy solutions.

To meet these new challenges and maximize our revenue generation potential, we must continue to improve the way we conduct our business. To this end, we have recently launched a major business transformation strategy that will make the best use of technology solutions, employees, and business processes.

When we have completed our transformation agenda, we will have established an operational framework that will "get the right work to the right people at the right time." We will do this by managing taxpayer collections and compliance issues holistically, using robust analytics, flexible business rules, and strategic risk management methodology.

While difficult, this challenge is not insurmountable. It requires significant initial investment, but we are confident that our agenda will generate efficiencies throughout the process, which we can re-invest in future transformation activities. We view our transformation agenda as a journey, and we are ready, willing, and able to seize the full potential of the opportunities that lie ahead.

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INTRODUCTION

In today's dynamic business environment, organizations must constantly be on the lookout for ways to become more effective. This challenge certainly holds true for private sector organizations searching for ways to maximize profit, but it also applies to government organizations, which must find ways to respond to new or increased service demands without corresponding increases in resource requirements.

Tax administrations are not immune to this challenge. They must preserve the tax base to keep the nation functioning, and do so within an environment of limited resources and evolving citizen expectations.

Because tax administrations perform a myriad of functions, there are many different ways to measure their effectiveness. Taxpayer satisfaction surveys, for example, may indicate whether citizens are satisfied with the organization's service delivery, and compliance levels may indicate whether the organization employs sufficient enforcement measures. Perhaps the most concrete gauge of a tax administration's effectiveness, however, is the extent to which it bridges the "collections gap;" that is, the difference between what could be collected and what is collected.

This objective is not easily achieved because tax administrations do not operate independently of the world around them. Despite how well managed an administration may be, external influences continue to pose challenges. Government priorities, for example, may shift in order to address emerging policy or socio-economic issues—taking scarce resources along with the change in direction. Unfavourable court decisions may result from contested tax administration decisions, creating additional (or confirming existing) tax loopholes for certain economic sectors.

Whatever the cause, be it limited resources, evolving citizen/ government expectations, legislative constraints, or other factors, tax administrations around the globe need to find innovative ways to increase their effectiveness while preserving the integrity of the tax system and protecting the nation's tax base.

So, how do we become more effective and reduce the collections gap? At a macro level, an obvious strategy for increasing revenue

would be to decrease tax expenses and tax evasion. In other words, by decreasing the costs of collection and increasing measures that encourage taxpayer compliance, tax administrations can achieve greater collection potential.

In more practical terms, tax administrations can maximize collection through any combination of the following strategies:

- Administrative innovation: Making better use of employees, innovating business structures and processes, and making better use of technology;

- Balanced facilitation and compliance control mechanisms: Making it easier for taxpayers to understand and meet their obligations voluntarily, and taking fair but effective enforcement action against those who do not voluntarily comply; and/or

- Legislative measures: Introducing legislative changes that impose stronger sanctions for non-compliance, but do not unduly burden the majority of taxpayers who are compliant.

Ultimately, the strategy selected by a particular tax administration to achieve potential collection will depend on the social and political environment in which it operates. The Canada Revenue Agency (CRA) has chosen to follow a strategy that encompasses all of the elements described above. We have recently launched an ambitious business transformation agenda that will make the best use of technology solutions, business processes, and employees, and through these administrative innovations we will develop tools that facilitate taxpayer compliance and support strategic legislative change.

When we have completed our debt management transformation, we will have established an operational framework that will “get the right work to the right people at the right time.” We will do this by managing taxpayer collections and compliance issues holistically, using robust analytics, flexible business rules, and strategic risk management methodology.

We have an ambitious business transformation agenda, but it is not insurmountable. This paper will share some of the challenges we are facing on this journey, our strategies for addressing them, and our experiences to date.

1. BACKGROUND

To understand the CRA's strategies for maximizing collections, it is helpful to review our mandate and organizational structure, fiscal impact and framework, and some key events from our recent history.

1.1 Mandate and organizational structure

1.1.1 CRA

The CRA is responsible for:

- collecting revenues and administering tax laws for the federal government and for several provinces and territories; and

- delivering certain benefit programs to Canadians through the tax system.

We have also recently assumed responsibility for collecting certain social program related debts.

The CRA has a unique governance framework. Like other government departments, our minister, the Minister of National Revenue, is fully accountable to Parliament for the CRA's administration of tax and benefit administration. Unlike other departments, however, we also have a Board of Management (BOM), which oversees the CRA's organization, administration, and management. BOM members are from the private sector, and are nominated by Canada's provinces and territories.

The only public servant on the BOM is the Commissioner, who fulfills the CRA's Chief Executive Officer functions. The Commissioner is accountable to the Minister for the CRA's day-to-day administration of program legislation, and to the BOM for our day-to-day human resource and general administration activities. This regime is unique in that the organization itself provides the CRA with a mechanism to incorporate provincial perspectives and private sector business experience into daily activities. Another difference is that the CRA maintains its own authorities for human resource and general administration, whereas these authorities rest with central government bodies for most federal government departments.

We deliver our programs through a number of functional branches and field offices. Functional branches such as Appeals, Assessment and Benefit Services, and Compliance Programs (auditing) set policy direction and provide oversight to field operations. Field offices such as Tax Service Offices (“TSOs”) and other specialty workload sites deliver the CRA’s programs.

The CRA’s collection functions are managed by the Taxpayer Services and Debt Management Branch (TSDMB).

1.1.2 TSDMB

TSDMB performs the following functions for the different acts and programs administered by the CRA:

- providing information and services to taxpayers and benefit recipients;

- collecting taxes, levies, duties, and non-tax debts; and

- promoting compliance with registration, return filing, and trust fund remittance requirements.

We are not responsible for activities such as accounting, returns processing, dispute resolution, or full tax return auditing. These activities are performed by other functional branches.

It is important to note that TSDMB manages collections and returns compliance activities together. We do so for two reasons:

- We know that resolving compliance issues such as filing and remitting together with collections issues ultimately results in increased revenue generation. We will pursue the collection of not only established debt, but also contingent debt that has not been established as a result of the taxpayer not having filed and/or remitted amounts due.

- We believe that this approach restores our citizens’ faith in the integrity of the tax system, by ensuring a level playing field for everyone. We do not disadvantage compliant taxpayers who meet their filing, remittance, and payment obligations by failing to pursue those who do not meet all of their tax obligations.

Six functional directorates report to an Assistant Commissioner:

- **Taxpayer Services** provides taxpayers with information and assistance to help them meet their tax obligations;

- **Revenue Collections Operations** coordinates field program delivery for our main business lines (Accounts Receivable and Trust Accounts);

- **Business Technology and Solutions** develops, supports, and provides maintenance for our technological applications;

- **Non-Tax Collections** explores debt management opportunities with other Canadian government departments (federal, provincial/territorial, and municipal), and coordinates field program delivery for our social program collection activities;

- **Strategic Planning and Debt Management Research** provides debt management research and strategic planning activities; and

- **Financial Planning and Management Services** provides quality assurance, human resource, and other branch support services.

1.2 Fiscal Impact.

1.2.1 CRA

The CRA plays a key role in Canada's economy, collecting approximately 95% of all government revenues. This translates into $313 billion annually—$1.2 billion every working day—including $40 billion collected on behalf of provinces, territories, and First Nations.

We also administer benefit and credit programs worth $12 billion annually, to over 10 million eligible citizens. To carry out this mandate, we have a workforce of over 43,000 in more than 50 sites across the country.

1.2.2 TSDMB

TSDMB contributes significantly to the CRA's fiscal impact. We manage an $18 billion tax collections portfolio, which represents approximately 5% of the CRA's total revenues. We also manage a $3 billion non-tax collections portfolio.

On an annual basis, we resolve over $12 billion in established debt (tax and non-tax), and assess a further $4 billion through compliance enforcement activities related to unfiled tax returns and unremitted source deductions and GST (VAT) remittances. In total, TSDMB has a fiscal impact of more than $16 billion per year.

We carry out our activities with an operating budget of $550 million and 10,000 employees.

1.3 Fiscal Framework.

The Canadian tax system relies on voluntary compliance and self-assessment. The CRA facilitates compliance through balancing quality service with responsible enforcement.

Quality service involves taking steps to make it easier for citizens to understand and meet their obligations. We strive to ensure that interaction with the CRA is quick, simple, and effective, and offer taxpayers a range of services through a variety of channels such as the internet, telephone, correspondence, or personal service. The CRA recognizes that many taxpayers prefer to meet many of their obligations via electronic self-service ("e-service"), and thus offer e-service options for activities such as completing forms, obtaining information guides, viewing account information, changing addresses, amending returns, and making payments. Plans are underway to expand the range of e-services even further.

Responsible enforcement involves detecting non-compliance and taking fair but effective enforcement action against those who attempt to evade their responsibilities. The CRA employs mandatory withholding and reporting mechanisms to prevent non-compliance for many sectors of the economy. We also use risk management techniques to detect non-compliance by identifying taxpayers who do not register, file, or remit as required, and we take definitive enforcement action to bring non-compliant taxpayers back into the compliance fold.

1.4 Key Events in Recent History.

Our business environment has been in steady evolution as far back as we can remember, and the pace of change is not expected to slow down in the foreseeable future.

The first key event of our recent history occurred in 1994, when the Office of the Auditor General (OAG) tabled a report recommending measures to improve collection activities. The Auditor General, an independent officer of Parliament, is responsible for ensuring that government departments and agencies properly and accurately report their financial activities, and that they operate efficiently and effectively. The CRA recognizes the value of such external oversight and initiated many collections re-engineering activities to address the OAG's recommendations.

One result of our re-engineering activities was the National Collections Call Centre (Call Centre), which opened in 1997. Based on the premise that earlier personal intervention would result in higher recoveries, we replaced computer-generated collection reminder notices with personal "soft" collection activity earlier in the collections cycle. Call Centre agents focus on client service by educating taxpayers on filing and payment requirements, attempting to restore them to compliance in lieu of immediately proceeding with costly enforcement measures.

Around this same time, we introduced the Revenue Enforcement Management and Tracking System (REMITS), which creates risk profiles for debtors, updates collections cases, and initiates follow-up strategies — one of which is a referral to the Call Centre. REMITS was successful in starting us on the path toward focusing our resources on activities where risk and potential payback are greatest.

In late 1999, the Department of National Revenue was transformed into the Canada Customs and Revenue Agency, now the Canada Revenue Agency. In creating a "revenue Agency", the Government of Canada wanted to achieve three objectives:

- provide better service to Canadians;
- become a more efficient and effective organization; and
- establish a closer partnership with Canadian provinces and territories.

Over the next few years, the CRA worked primarily toward meeting the first two objectives. We modernized our human resource and administrative systems, in order to provide us with the capacity to deliver our programs with a professional workforce and a strong management regime. Now that we have transformed internal operations, our focus has shifted toward meeting the third government objective, improving existing partnerships with provincial and territorial governments and seeking out additional partnership opportunities.

While these agency-level changes were underway, we continued to re-engineer our debt management operations. To further integrate our compliance activities, we received the Non-Filer/Non-Registrant program from another branch; this change meant that TSDMB became responsible for return filing enforcement activities for all business lines. We also took preliminary steps toward eliminating geographical workload boundaries by creating “national pools” of accounts that could be worked by collections and compliance officers anywhere. As well, we began exploring possibilities for a new technological platform that would provide us with significant efficiency gains. These changes will be discussed in more detail below.

Two major structural changes occurred in 2004. The first was that our Customs responsibility (except for the collections function) was transferred to the newly created Canada Border Services Agency, as part of a federal government reorganization exercise. The second was the creation of the Revenue Collections Branch. Formerly a directorate within the Assessment and Collections Branch, our transformation to branch status signified the growing importance of Revenue Collections programs in the context of the CRA’s mandate.

Organizational and business changes continue into the present period of time. In 2006, we have realigned our organization once again to bring strengths and expertise together and improve our focus on core business activities. We have transformed the Revenue Collections Branch into the Taxpayer Services and Debt Management Branch (TSDMB), bringing front-end taxpayer service and debt management together. This transformation signifies the CRA’s recognition that the compliance continuum starts with providing proper support to encourage voluntary taxpayer compliance. We will help taxpayers meet their tax obligations at the front end of the compliance continuum, and we will take enforcement measures at the back end of the continuum where they fail to do so.

The OAG is also about to complete a follow-up audit of their 1994 report, and results are to be issued in the spring of 2006.

Finally, major business transformation activities relating to people, process, and technology are under development. These business transformation activities are the focus of this paper.

2. CURRENT DEBT MANAGEMENT PROCESS

These preceding events have certainly influenced the way we conduct our collections and compliance activities, which are perhaps best described in terms of workflow and risk management strategies.

2.1 Workflow Strategy.

For all collections and compliance workloads, our standard method of operation is to allow our computer systems to manage cases for a pre-defined “routine” period of time. Cases that are not resolved during this period typically flow to the TSO closest to the taxpayer’s location of residence for resolution, where they may flow to more senior level officers for resolution when they become more complex.

In recent years, we have experimented with this process by flowing more workload through the Call Centre and creating national inventories to resolve workloads once they flow to the “TSO resolution” stage. For example, we now flow individual debt and GST (VAT) collections and compliance workloads through the Call Centre during their respective routine periods, whereas they were previously subject to only computer-generated notice activity. We also run “campaigns” through the Call Centre during non-peak periods on lower value and missed instalment workloads, which would previously not have received personal agent attention. As well, rather than routing all unresolved collections and compliance workloads to the closest TSO (which may not currently have the capacity to resolve them quickly), certain workloads now flow to national pools where members across the country can work them as the first step in the TSO resolution stage. These experiments have been so successful that we have incorporated them into our regular business process.

2.2 Risk Management Strategy.

We also follow a risk management strategy to manage some of our workloads, using automated risk scoring and case management tools to assign a collections case management strategy or determine whether a potential non-filer case merits further enforcement action.

Based on certain criteria, our computer systems will assign a numeric risk score to the case at hand. Depending on the score:

- a collections case will remain in routine collection status, or will flow to the Call Centre or TSO for immediate action; and

- a non-filer case will flow to an officer for filing enforcement action, or will be inactivated if it is not expected that filing enforcement action will generate a significant debt.

For all workloads, complex risk factors such as case history or associated debt are considered when the case flows to the respective TSO for resolution.

3. CURRENT CHALLENGES

While we have certainly improved our debt management operations through initiatives such as those described above, we continue to face significant business challenges.

3.1 Collections Portfolio Is Growing and Getting Older.

One challenge we face is the continued growth and aging of our collections portfolio. Our funding does not increase when we inherit more cases (“intake”) than expected, so when actual intake exceeds expectations, our inventories grow larger and get older.

We can only resolve cases using the resources available to us. When intake is greater than expected, we cannot resolve every case we receive, which means that many cases remain unactioned for a longer period of time. This is problematic because we know that the longer a case remains outstanding, the more likely it will become uncollectible. An aging collections portfolio makes it more difficult to maximize collections.

We know that we will not be able to obtain additional wholesale funding, so we need to find strategic ways to address our workload using available resources.

3.2 Technology Does Not Meet Today's Business Needs.

Another challenge is that our technology does not provide solutions for our current business needs. When our collections and compliance systems were developed more than 25 years ago, they were built to meet the organization's needs of the day. At the time, our business environment was fairly static, so detailed reporting facilities were unnecessary. As well, taxpayers were less sophisticated, so it made sense to put everyone through the same workflow process. Furthermore, most of our workload was paper-based, and we managed our collections and compliance programs separately.

The environment in which we now operate is dramatically different. Constant change surrounds us. We need to have infrastructure in place that will help us respond effectively to current and future challenges. To develop this infrastructure, however, we need to be able to differentiate performance problems that respond to efficiency measures from systemic issues that require us to rethink our approach to parts of our operations. We need technology solutions that will help us assess our performance in greater detail.

Taxpayers have also become more sophisticated, and have found innovative ways to avoid meeting their collections and compliance obligations. We need to be able to quickly identify and understand these emerging trends and their associated risks, so that we can develop effective strategies for addressing them as early as possible. Fortunately, the CRA now receives a vast amount of information electronically, through such initiatives as e-filed returns. The time is right to use this information more strategically, so that we can make debt management decisions based on robust risk analysis and risk management.

We have also experienced a shift from a paper-based environment to the electronic age since our systems were built. As technological advances have emerged, the CRA has taken advantage of them to provide taxpayers with better service. For example, taxpayers can now view their tax information and conduct certain transactions with the CRA via electronic means. In light of the need to manage our programs with limited resources, we need to exploit technology further, to gain

administrative efficiencies. One way we can do this is to automate debt management activities where it makes sense to do so. We could, for example, automate more low-value tasks such as submitting uncollectible debts for deletion, and more high-value tasks such as risk-based workload allocation.

Finally, during this period of change, we have also learned that taxpayer collections and compliance issues are rarely resolved independently of each other. Addressing every collections or compliance "case" that arises is a sound way to manage every single issue identified, but does not recognize that many of our taxpayers have multiple debt management issues. We need technology solutions that will provide us with the ability to quickly and completely analyze our taxpayers' total debt management situation.

For all of these reasons, we need to modernize our business systems so that they provide us with the capacity to manage our business in today's dynamic environment.

3.3 Core Business Activities Are Expanding.

Now that the CRA has matured its agency status, our focus is shifting to strengthening existing partnerships and building new relationships with other government bodies—one of the reasons why the CRA was created.

TSDMB's contribution toward this goal is to become responsible for collecting additional accounts receivable on behalf of federal, provincial/territorial, and municipal governments. We aim to be recognized as the federal government's main service provider in debt management by 2010. Integrated debt management also aligns with the Government of Canada's service vision, which encourages increased horizontal management of corporate functions and more collaboration across government. Removing operational borders ("silos") provides better service to citizens, and makes government more efficient and effective.

We have begun the collections integration journey by legally transferring the collections function (employees and portfolio) of other departments' social programs to the CRA on August 1, 2005. We are now responsible for collecting debts such as overpayments or repayments under the Canada Pension Plan and Employment Insurance programs, and the collection activities of the Canada Student Loans program.

This initiative presents an enormous opportunity for the CRA, but certainly offers challenges to our service delivery infrastructure—particularly relating to technology and legislation. From a technology perspective, our key challenge will be to develop a technology solution that efficiently integrates and manages all taxpayer/citizen issues (tax + non-tax collections, compliance, future debt management workloads). From a legislative perspective, our key challenge will be to obtain tax policy solutions that will give us the legal authority to use tax information to collect non-tax debts.

We will still be able to take on new business without obtaining these solutions, but efficiency gains will surely be missed if we do not have full information-sharing legal authorities in place.

3.4 Legislative Constraints.

Another challenge facing us is the difficulty in obtaining tax policy solutions for collections and compliance issues.

In Canada, tax policy is set by the Department of Finance (DOF) rather than the CRA, which sets only administrative and operational policy. It has sometimes been difficult to gain Finance's commitment for tax policy change, because the DOF must balance our requests with other competing policy interests of the nation. Furthermore, as described previously, we have not always been able to support our requests for change with empirical data that quantifies particular collections or compliance issues. Not surprisingly, Finance has been reluctant to amend legislation without accurate and reliable information that substantiates a suspected revenue leakage and its root cause(s).

Like all tax administrations, we are responsible for ensuring that we have an effective legislative framework in place that will help us achieve our mandate. We recognize the need to balance effective enforcement measures with a tax system that does not unduly burden citizens. That is why we follow a responsible enforcement strategy in our daily operations—strategically targeting collections and compliance enforcement actions toward those who do not comply. We know that we need to take a similar approach in seeking legislative change.

We need to collect meaningful data on problematic debt management issues in order to seek strategic legislative change that will protect the revenue base and ensure that everyone pays only their fair share.

4. STRATEGIES FOR ACHIEVING POTENTIAL COLLECTIONS

To address these challenges, TSDMB is currently analyzing options and developing new systems that will modernize the way we conduct our business. Ultimately, all of our business transformation activities flow from our Strategic Plan, which outlines the following five strategic directions:

- **Developing an integrated, taxpayer/citizen-centred approach,** which will progressively integrate all taxpayer/citizen collections and compliance issues.

- **Building a new technological platform,** which will facilitate our migration toward a taxpayer/citizen-centred approach and provide us with the ability to strategically use the information we collect.

- **Pursuing legislative amendments,** which will allow us to strategically address systemic collections and compliance issues, and improve our operational framework.

- **Supporting our employees,** by providing them with the knowledge and competencies necessary to complete their work as we transform our business.

- **Strengthening existing debt management partnerships, and pursuing new opportunities,** as a result of leveraging our taxpayer/citizen-centred approach and flexible technology.

In practical terms, our business transformation strategy has three key components: technology, people, and process. Major projects are underway to implement these components concurrently.

4.1 Technology Solutions.

In what may be the most significant development in TSDMB history, we are currently developing a technology platform that will transform our operations and position us as a debt management service provider of choice.

4.1.1 Project overview.

The Integrated Revenue Collections project (IRC) is the technological foundation of our business transformation. It will replace our multiple aged standalone computer systems with a single technology platform that offers us many opportunities for effectiveness and efficiency gains. It has several key features:

- **Taxpayer/citizen-level view of revenue collections issues and events:** IRC will integrate all TSDMB workloads for taxpayers/citizens, which will allow us to focus on all collections (tax + non-tax) and compliance issues, rather than only the case at hand.

- **Robust risk assessment and risk management:** IRC will use sophisticated risk assessment and risk management methodologies such as data mining and predictive modeling to identify and address risks to CRA programs. Risk will be assessed and managed at the taxpayer/citizen level, rather than at the case level. This will help us use our resources more efficiently by showing us where to target enforcement activities in order to gain the greatest impact.

- **"Intelligent" workload allocation tools and processes:** IRC will replace resource-intensive, manual processes for workload identification, allocation, and resolution with automated strategies that are based on risk.

- **Improved case management tools and practices:** IRC will have adaptable work processes and flexible business rules. This will allow us to quickly redirect work to where capacity exists, and respond to CRA or other government priorities without being tied to lengthy mainframe change cycles.

- **Effective performance measurement and reporting tools:** IRC will replace resource-intensive, manual processes for performance measurement with automated tools that convert data into useful management information at strategic and operational levels of detail.

In short, IRC will provide us with the ability to use the information the CRA already collects more strategically, and will automate many resource-intensive, manual processes. It will help us identify, manage, and distribute workload, and measure our results more efficiently—which will ultimately lead to increased revenue generation.

4.1.2 Progress to date.

IRC is a large, multi-year endeavour, and consists of many sub-projects. Project visioning started several years ago, when we began to conceptualize a strategy and develop a practical understanding of what we could achieve with new technology. Once we had defined the vision, we worked on identifying resource requirements and securing funding.

Funding was provided in late 2004, and the project was officially launched at that time. Since then, we have been busy with project design, development, and building activities. We have established a project team, identified and prioritized sub-projects, and documented business requirements. We are now developing technical architectures and specific business solutions.

This project is certainly a journey whereby we will achieve success over time. We plan to migrate the first taxpayer group (individual non-business taxpayers) to the new technology platform during the next two years. Non-tax collections will begin moving to the new platform in year three, and remaining tax business lines (corporate tax, goods and services tax, and source deductions) will follow thereafter.

4.1.3 Challenges and solutions

With a project as large and encompassing as IRC, it is natural to encounter challenges along the way. Some of the issues we have encountered thus far relate to securing early investment, managing risk, and working within legislative constraints.

Investment funding

All changes have cost implications, and large-scale changes definitely require early investment before they generate efficiency savings.

To fund a project as large as IRC, it was necessary to obtain additional funding from the Government of Canada. A significant amount has been invested in the project, but compared to the more than $300 Billion we collect every year for the federal government, it is money well spent. We fully expect that this initiative will generate significant cost savings, which we will reinvest to fund future transformation activities.

Managing risk

Given the large amount of changes involved and the significant investment made to complete them, we are very conscious of the need to deliver promised outcomes. We know that any number of issues could place the project at risk; for example, different technology solutions might develop compatibility issues or fail to deliver expected results. We also know that we need to protect the delivery of our core activities during the project's development and implementation.

To mitigate these risks, we are following an iterative approach. Instead of implementing all of our new technology at once, we plan to introduce changes progressively through multiple "releases." By introducing changes over time, we will prevent major disruption to our program activities and give our employees time to adjust—during which time we will maintain our existing business systems as a safeguard. This approach will also provide us with an opportunity to prove technological concepts and adjust applications still under development as a result of feedback on changes released along the way.

Legislative constraints

We recognize that advances in technology such as data mining and data matching can create privacy risks, and strive to ensure that our technology plans do not contravene privacy law. Like many nations around the globe, Canada is concerned with protecting its citizens' privacy, and has created a legislative framework to enshrine privacy rights. Legislation was established to govern the use of personal information for both government and private sector purposes, and the Office of the Privacy Commissioner of Canada (OPC), was created to provide citizens with an official privacy rights advocate. Like the Auditor General, the Privacy Commissioner is an independent officer of Parliament, and is responsible for monitoring privacy issues and investigating complaints.

The CRA recognizes the value of the OPC's oversight. We work collaboratively with the OPC to ensure that our system changes will not contravene Canadian privacy law. We also complete Privacy Impact Assessments (PIAs) for various project components, in which we identify potential privacy risks and outline strategies for mitigating them.

4.2 People and Process Solutions.

For our business transformation strategy to be successful, we must modernize not only our technology but also our business processes and use of employees. Consequently, we have launched a second major initiative to examine the way we conduct our operations.

4.2.1 Project overview.

The 2010 National Program Service Delivery Model project is our strategy for transforming the "people and process" side of our business. Using a task force approach, HQ and field representatives are examining TSDMB's current operations, and developing an organizational blueprint that takes advantage of the opportunities afforded by our new technology. They are also developing an implementation strategy to help us transition to the new model.

Workload analysis

The Task Force project team is considering national, specialized, and general workload issues, and has targeted the following areas for detailed analysis and potential redesign:

- the Call Centre;
- National pools;
- non-face-to-face workloads; and
- face-to-face workloads.

These four areas essentially represent our current collections and compliance processes. As described previously, the Call Centre and national pools manage selected "national" collections and compliance workloads; that is, workloads that can be resolved by an agent located anywhere in Canada. Other workloads, which may or may not require face-to-face interaction with taxpayers, are managed by the TSO closest to the taxpayer's geographic location.

Project members will consult with employees across the country in order to assess the effectiveness of current business strategies used to distribute and resolve work at these centres. Once project teams have completed this review, they will develop recommendations for our future operations, considering such aspects as:

- the types of work that should flow through the Call Centre, national pools, TSOs, and other recommended centres of expertise;
- the types of work that should be integrated, the degree of integration required, and strategies for integration;
- the business rules that should be followed in order to facilitate workflow process;
- a strategy for workload distribution;
- the technology and other tools necessary for employees to complete their work;
- the resources and budgets required to manage redesigned TSDMB processes; and
- the reporting requirements and performance measurement criteria.

For example, as part of the Task Force's review of the Call Centre's operations, it will consider the feasibility of adding new workloads (such as source deductions and/or non-tax debt collections) to the revenue lines already collected by Call Centre agents.

Organizational and human resource analysis

Once the Task Force has defined new workload processes, it will focus attention on organizational and human resource issues. Following the same approach used to analyze TSDMB's workloads, it will examine current practices and make recommendations for a future design, considering such elements as:

- the optimal number of service delivery sites;
- ways to improve our resource model to make it more reflective of modernized work processes;
- the classification groups and levels we need our employees to have;
- the competencies we will require our employees to have, and a plan for recruiting and/or developing qualified employees; and

- a strategy for making TSDMB an attractive career path for employees.

For example, as part of the Task Force's examination of human resource issues, it will explore the feasibility of creating a "technical stream" for recruiting (or developing) employees into specialized positions that manage our most complex workloads.

4.2.2 Progress to date.

The Task Force project was launched only a few months ago. Sub-project teams have been established, and members are currently finalizing planning activities. In the coming months, members will focus on design, development, and building activities, performing activities such as mapping business processes, gathering statistics, documenting business rules, and identifying technology and legislative requirements. High-level discussions have been held with TSDMB's management team regarding the project's mandate and approach, and consultation with the field has begun. Initial feedback suggests a high level of support for the project's objectives.

The first two areas targeted for development are the strategies for maximizing our use of the Call Centre and national pools.

4.2.3 Challenges and solutions.

One key issue must be considered by the Task Force — ensuring that project recommendations align with larger Agency initiatives.

Alignment with the CRA's 2010 vision

As part of the CRA's planning framework, a high-level strategy for transforming the way we conduct all of our business is underway. A key priority for the CRA during the next five years will be to build better relationships with other federal departments and agencies, and the provinces and territories. It is imperative that we align TSDMB's transformation strategies with the CRA's 2010 vision.

We can easily align our business transformation plans with those at the agency-level, by continuing to develop strategies for leveraging our infrastructure in order to attract new debt management business.

We will also ensure alignment by keeping potential non-tax workloads in mind as we redesign our technology and business processes.

In fact, we have already started this process by assuming responsibility for social program debt collection — which we are now integrating into our developing technologies and business processes.

4.3 The Key to Successful Transformation.

Clearly, to achieve our business transformation goals, we need to implement technology and people/process solutions together. Our transformation strategy reflects this understanding.

On the technology side, we will use IRC's technology to "mine" taxpayer data held in the CRA's data "warehouses" using strong business analytics, and use this data to build risk profiles and automated strategies for routing work where it will be most effectively resolved.

On the people/process side, we will implement Task Force recommendations to take advantage of the opportunities afforded by our new technology. Through our enhanced analytic capacity, we will gain a better understanding of taxpayer behaviour and the effectiveness of different debt management strategies.

Ultimately, by balancing technology and people/process transformation components, we will be able to make better business decisions on:

- how to refine our workflows and work processes;
- the business rules that will identify workloads and assign strategies to fit into these refined workflows and work processes;
- the case management strategies that will route workloads according to these refined strategies;
- the best organization structure and governance regime that will support our work activities; and
- how to use our enhanced performance reporting tools to continually refine our operations.

5. FUTURE DEBT MANAGEMENT PROCESS

When we have completed our transformation agenda, we will have established an operational framework that will "get the right work to the right people at the right time."

We will continue to utilize workflow and risk management strategies, but they will be much more strategic and robust as a result of our integrated taxpayer/citizen approach and new technology.

5.1 Workflow Strategy.

As before, collections and compliance workloads will flow from computer-controlled to agent resolution strategies. However, rather than flowing independent cases through separate work streams for standard periods of time, they will flow to a resolution strategy much earlier in the process — based on a comprehensive risk management strategy.

5.2 Risk Management Strategy.

As before, our business systems will assess risk and assign resolution strategies. However, rather than doing so for only certain workloads, using basic risk scores that analyze only the collections or compliance case at hand, our new system will perform robust risk management for the taxpayer's/citizen's complete collections and compliance situation. Using sophisticated methodologies such as data mining and predictive modeling, the system will identify all that is "wrong" with the taxpayer's/citizen's complete situation, and assess the level of risk associated with the problem(s). It will then route the integrated case to the most effective resolution strategy defined by our new business rules and work processes.

CONCLUSION

Through our collection and benefit administration activities, the CRA impacts virtually all Canadians. TSDMB employees are directly involved with thousands of Canadian citizens every year, helping them to comply with their tax and other government debt obligations. Our actions have

significant impact on taxpayers' voluntary compliance and the way they perceive the integrity of the tax system — which ultimately provides our nation with a steady revenue stream to sustain the delivery of government programs. Given our significant influence, we need to continuously improve our operations, to ensure that we are providing the citizens of this country the best value for their money.

We recognize this tremendous responsibility, and have taken innovative steps to transform our debt management activities. Our business transformation agenda is ambitious, but attainable. We will decrease our operational costs by increasing administrative efficiencies and organizational effectiveness. Our approach requires significant initial investment, but we are making resource and investment decisions based on actual outcomes and value realization throughout the transformation. We are confident that we will be successful in generating significant savings during the transformation, which we will harvest to re-invest in further transformation activities.

We believe that our approach will position the CRA as an attractive debt management service provider to other levels of government, thereby contributing to a key objective behind the CRA's creation. Our transformation will also help us continue to take advantage of opportunities afforded by the Government of Canada's service vision for horizontal and collaborative government. We will continue to explore insourcing non-tax government debt where it makes sense to do so, and build on the momentum we started when we assumed responsibility for social program debt management activities.

Enormous challenges await the CRA and the TSDMB, but we are ready, willing, and able to seize the full potential of the opportunities that lie ahead.

GLOSSARY

Auditor General for Canada (OAG)	Independent officer of Parliament responsible for ensuring that government departments and agencies operate efficiently and effectively, and properly and accurately report on financial activities.
Collections workloads	Recovery of all outstanding taxes, levies and duties administered by the CRA and withheld in trust on behalf of the CRA; for example, individual tax, corporate tax, payroll taxes (federal and provincial income tax, Canada Pension Plan, Employment Insurance plan), goods and services tax, customs duties, Air Transportation Security Tax, benefit program repayments.
Compliance workloads	Enforcement of registration, return filing, and remittance requirements for CRA business lines; for example, individual tax, corporate tax, payroll taxes (federal and provincial income tax, Canada Pension Plan, Employment Insurance Plan), goods and services tax.
CRA E-services	Various options for individuals and businesses to transact with the CRA using the internet; for example, My Account, which allows individuals to view tax and benefit information and conduct certain transactions with the CRA online.
Data mining	Process for analyzing large volumes of data using various automated techniques, to facilitate the discovery of meaningful information that will support business decisions.
Agency Data Warehouse	Central repository of information including data extracted from various CRA source systems.
Department of Finance	Federal government department responsible for providing Parliament with analysis and advice on Canada's economic and financial affairs through activities such as preparing the federal budget and tax and tariff legislation.
Geography of Work	TSDMB initiative to examine alternatives to traditional geographical boundaries for workload distribution.

Government of Canada's service vision	Federal government initiative to identify opportunities for shared services between departments in order to gain efficiencies and provide better service to citizens.
Goods and Services Tax	Value added tax on the supply of most goods and services in Canada.
Governance	The framework by which people, process, and technology are managed.
Government On-line (GOL)	Federal government initiative to provide most government information and services on the internet, thereby providing citizens with enhanced access to citizen-centred integrated services, anytime, anywhere, and in the official language of their choice.
Intake	Volume of collections and/or compliance cases received, defined by the number of cases received and/or the dollar value of cases received.
Integrated Revenue Collections (IRC) Project	Technological foundation of TSDMB business transformation. Key features include: comprehensive risk identification and quantification, integrated taxpayer/citizen-level view of collections/compliance issues and events, intelligent workload allocation tools and processes, improved case management tools and practices, and effective performance measurement and reporting. Features will facilitate TSDMB's people/process transformation initiative (Task Force).
National Collections Call Centre	Centralized inbound/outbound call operation. Responsible for: collecting individual and GST debts and outstanding GST returns within specified parameters and responding to related enquiries, operating the national e-filing help desk, responding to overflow TSO general enquiries calls, and operating a specialized call site for responding to credit program general enquiries.

National pools	Virtual “offices” which enable agents to resolve work from any location across Canada. Responsible for: the collection of individual debts within specified parameters, and the collection and compliance (return filing and remittance enforcement) of source deductions and GST workloads within specified parameters. Represents the first step in the “TSO resolution” stage of debt management.
Non-tax collections	Collection of debts that result from the administration of other (non-CRA) federal department programs, e.g., overpayments/ repayments of the Canada Student Loan, Canada Pension Plan, and Employment Insurance programs.
Predictive modeling	Assessment of taxpayer/citizen characteristics and behaviours to identify and categorize the risk of non-compliance.
Privacy Commissioner for Canada (OPC)	Independent officer of Parliament responsible for researching and promoting awareness of privacy issues, and investigating citizen complaints of privacy violations by private or public sector organizations.
Privacy Impact Assessment (PIA)	Process for helping organizations determine how program and service delivery initiatives may impact individuals’ privacy and identify options for mitigating identified risks.
Revenue Enforcement and Tracking System (REMITS)	Automated organizer that assesses risk and assigns strategies (e.g., continued computer monitoring, Call Centre or TSO action) for incoming individual and corporate tax debts.
Risk scores	Numeric values used to calculate a probability that a particular non-compliant taxpayer/client account can be made compliant.
Routine status	Initial period of time after a tax debt is assessed, before the file is assigned to a collections agent.

Tax Service Office	CRA offices located across Canada. Responsible for delivering CRA programs and activities, e.g., audit, dispute resolution, collections and compliance.
Source deductions	Amounts deducted from employee wages and withheld in trust on behalf of the CRA, e.g., income tax, pension plan, and employment insurance amounts.
Trust funds	Prescribed amounts deducted from employee wages (federal and provincial income tax, and employee contributions to the Canada Pension Plan and Employment Insurance programs) but not remitted to the CRA, and prescribed amounts collected or deemed to have been collected under the Excise Tax Act (GST) and Air Travellers Security Charge Act.
TSDMB 2010 National Program Delivery Model	People/process foundation of TSDMB business transformation. Key features include: examination of current workload, organizational, and human resource operations, and recommendations for improvement. Recommendations will take advantage of and work together with TSDMB's technological transformation initiative (IRC).

Case study

TOPIC 2.1

ADMINISTRATIVE INNOVATION AS A WAY OF GUARANTEEING TAX RESOURCES

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CONTENTS: 1. Structural Adjustment.- 1.1. A single interlocutor for large corporations: Large Corporations Directorate (DGE).- 1.2. A single interlocutor for small and medium-sized enterprises: Enterprise Tax Service.- 1.3. A single interlocutor for individuals.- 1.4 Professionalization of the activity – competency hubs.- 1.5 Means available to the tax administration to combat tax fraud: Regional Intervention Groups.- 2. Adjusting the Tools.- 2.1. The Copernic Information System.- 2.2. Improving user relations.- 3. Management Control Enables Assurance of These Innovations.- 3.1 Simplified taxation.- 3.2 Allowing users to fully enjoy their rights as soon as possible.- 3.3 More thorough knowledge of the tax population.- 3.4 More responsiveness vis-à-vis delinquency and reporting non-compliance.- Conclusion.

In the framework of its objectives for the 2006-2008 period, the General Tax Directorate (DGI as per the acronym in French) sets out to make progress on two areas – enhancing user relations and increasing tax collection.

Enhanced user relations lie in higher service quality, mostly enabled by new technologies and the creation of a “one-stop shopping” system for filings.

Simplification of taxpayer-users’ tax obligations raise tax awareness and, together with the maintenance of high standards for control activities, lead to better tax collection.

Regarding the first area, the DGI has primarily undertaken a reform of its structures.

Into the future, both the structures aimed at managing the taxes of large corporate groups and small businesses shall be more oriented to user concerns.

- The *Large Corporations Directorate* (DGE as per the acronym in French) is the only interlocutor for corporations with business turnover or gross assets in excess of 400 million •.
- The *Corporate Tax Service* (SIE as per the acronym in French) serves small and medium sized enterprises.
- Likewise, individuals now have the option of making all their filings in a single unit, thanks to the creation of financial delegations called “Hôtels des Finances”.[1]

Now, this priority emphasis on administration-user relations should not conceal another concern of the DGI, namely that of combating tax fraud.

Regarding the latter, in addition to existing addresses and services in the area of tax control, in 2002 Regional Intervention Groups (GIR) were created, to work jointly with Customs and the Police. These have efficient means to combat financial crime and the underground economy.

Finally, these structural reforms were prepared based on a set of tools aimed at modernizing the tax administration. Their priority objective is to restructure IT systems. This restructuring, which targets the creation of a single tax account, enables users to select a contact channel with the tax administration which they find more convenient (telephone, Internet, mail).

Both individual and professional users can now access a host of services, the most noteworthy being the possibility of filing returns and paying taxes over the Internet.

[1] In the past, the functions of determining the tax base and direct tax collection were divided between the DGI (tax base) and the Public Accounts Directorate (DGCP) (collection).

However, these innovations should be subject to controls in order to ensure they are truly efficacy. This is where it becomes of utmost importance to have management control and indicators to measure the evolution of efficacy over a given period.

The following 2005 figures illustrate the DGI's mission:

- 34 million fiscal homes;
- 50 million individuals;
- 3.6 million enterprises and professionals**.**
- As at 31 December 2005, net VAT collections amounted to 145,200 million Euros.
- As at 31 December 2005, the net Corporate Tax (IS as per the acronym in French) collection amounted to 42,700 million Euros.

1. STRUCTURAL ADJUSTMENT.

1.1 A Single Interlocutor for Large Corporations: Large Corporations Directorate (DGE)

1.1.1 Historic overview.

The organization of the General Tax Directorate should effectively respond to the needs posed by the tax management of large corporations.

The creation of the Large Corporations Directorate (DGE) on 1 January 2002 illustrates the overall efforts made by the DGI with a view to simplifying its relationship with taxpayers / users while improving the functioning of Government.

Large corporations are ruled by tax systems posing complex and, in some cases, specific issues. These corporations are located both within the national territory and abroad, and their tax management if often centralized at the level of the group's holding company.

The Large Corporations Directorate is thus responsible for determining the tax base and collecting all taxes from corporations with bottom-lines or gross assets in excess of 400 million Euros.

It is a sizeable budgetary challenge.

1.1.2 Competencies.

- “One-stop Shopping” System

As part of the endeavor to simplify formalities for corporations, the DGE has become the substitute for the numerous interlocutors existing in the past. Large corporate groups now have a single interlocutor to file returns and pay major taxes.

- Electronic Filing of Returns and Payment

Electronic messaging (large corporations have dedicated Internet space), fax and phone facilities are privileged communication means in daily interaction with enterprises. Thus, most of the formalities they need to undergo before the DGE are completed either online or remotely:

- secure procedure for remote VAT returns or profit (or loss) reports,
- secure procedure for remote VAT, corporate tax, economic activity, payroll and land tax payments, even if these corporations have hundreds of widespread establishments over the territory.

Paying several taxes under the same accounting line further enables the setting up of a single account and offers enterprises the possibility of offsetting taxes accrued with a balance in favor of the taxpayer as a tax credit. This is a considerable simplification for enterprises.

In addition to the principle of “one-stop shopping”, the DGE’s internal organization has been designed to offer corporations a single tax interlocutor which is clearly identifiable and competent to manage their taxes.

1.1.3 A few key figures.

- Corporations

The DGE currently manages the taxes of 30,000 corporations.

In the future, 35,000 additional corporations shall enter its scope of competency.

The DGE collects:

- 33 % of the total amount of national Value Added Tax (VAT),
- 50 % of the total amount of Corporate Tax,
- 45 % of the total amount of Economic Activity Tax.

In 2005, the DGE's collection reached 105 billion Euros. Of this total,51.5 billion are accounted for by VAT, 25 billion by Corporate Tax and 15 billion by Economic Activity Tax. Likewise, 25 billion Euros were refunded as VAT credit rebates and various other reliefs.

By way of example, the DGE serves large corporate groups of global recognition such as Bouygues, Total Fina, Renault, Carrefour, etc.

- Structures and officials

The DGE has 315 officials.

It is structured in 14 Single Tax Interlocutor teams, comprising 8 to 12 officials each.

Each Single Tax Interlocutor team or "IFU" (as per the acronym in French) has competency to process all tax formalities – due dates of returns, current collection, claims and tax credit refund requests. These teams are organized by social and professional groups and sectors, and act as comprehensive corporate interlocutors, thus ensuring specialized, expeditious and personalized service.

1.2 A Single Interlocutor for Small and Medium-sized Enterprises: Enterprise Tax Service.

1.2.1 Historic Overview.

In the past, the organization of the General Tax Directorate Focused on the tax administration's internal procedures. There were different competent structures for the on-going management of taxes paid by corporations:

- "Tax centers" for determining the tax base,
- "Tax collection services" for VAT collection,
- "Treasury services" for collection of payroll tax, the tax on economic activity and land taxes.

Each corporation had to resort to several different interlocutors. The chain of processes found cracks which entailed the risk of errors. On the other hand, in the small structures, the teams were sometimes not sufficiently trained to serve users in the best condition.

In 2001 – with gradual implementation up to 31 December 2005), the decision was taken to group tax centers and tax collection services with the purpose of improving:

- The service provided to SME's owing to the establishment of a single tax interlocutor. The preparation of files, the work carried out to determine the tax base for taxes on economic activities, and VAT collection were grouped under the management of the same team. This allowed for a reduction of the terms for obtaining information and providing the most usual services (return systems, payment terms, resolution of simple claims, refund requests, etc.). Thus, the number of contacts between corporations and the DGI has been reduced.

- The DGI's performance, owing to a less siloed, more resilient and responsive organization which allows for expediting delinquency redress and improving coordination of collection activities.

1.2.2 Competencies.

The creation of the *Corporate Tax Service* as a single interlocutor for corporations helps to offer a better response to user concerns.

Currently, the reunification of tax centers and tax collection services is geared toward having our organization focus more on small enterprises.

Furthermore, the transfer of tax collection responsibilities to this single Service considerably simplifies the work of corporations, which no longer need to adjust to the tax administration's organization.

Thus, returns and corporate payments are subject to more thorough follow up, the administration's responsiveness is greater faced with non-compliance and control activities may be better focused on chronic delinquency cases.

1.2.3 Recent or future evolutions.

Until the reform, taxpayers had two main interlocutors in France: the Tax Centers, reporting to the General Tax Directorate, for all issues relative to tax calculations and returns; and the Treasury (or collections) Services, reporting to the General Directorate of Public Accounting, for all issues relative to tax payment.

The creation of the *Corporate Tax Service* was preceded by the delegation by the General Tax Directorate of collections of wage tax effective 1 January 2004 and corporate tax, effective 1 November 2004. Both taxes were collected by the Public Accounting Directorate. The General Tax Directorate services became responsible for collecting both taxes in better condition.

Collection increased by 5% on wage tax from 2003 to 2004, and 0.8% (gross collection) on corporate tax, from the first half of 2004 to the first half of 2005.

The unification process which shall ultimately result in the institute of a single tax interlocutor for corporations shall be completed in 2008 upon the transfer to the DGI of the responsibility for collecting economic activities' taxes and land tax on legal persons.

This transfer involves around 1.5 million tax notices. Collection of economic activities' tax shall imply 3.3 million tax notices.

1.2.4 Key figures.

Resources

788 restructured units
577 SIEs and 211 CDI/SIEs
15,800 jobs

VAT

93.7 billion Euros collected by SIEs.
33% by electronic payment systems before the SIEs.

Corporate Tax

1.4 million corporations
26 billion Euros worth of gross collection.

1.3 A Single Interlocutor for Individuals.

Objectives

The objective is to allow taxpayers to complete their most important tax formalities before a single interlocutor wherever they may be.

The creation of Financial Units (Hôtels Des Finances -HDF), which host in the same premises both the General Tax Directorate and the Public Accounting General Directorate, enables enhanced services for users, since it allows them to complete all of their tax formalities in a single office.

In urban centers, an ambitious property program was set in place for the development of these Financial Units (Hôtels Des Finances), which shall host in the same premises both tax centers and public treasury services, to offer users a unique service enabling them to complete all the required formalities in a single visit.

- of the 230 projects selected to be launched over a 3-year period, 100 shall start as from 2006.

In rural areas, these property unifications are not possible on account of the different territorial coverage existing between the tax service networks and the public treasury networks (there are around 800 tax centers and 2700 treasury services with tax competencies across the national territory). This is the reason for the upcoming creation of cross-competency units to allow users to complete their formalities on either network. This new service is in the experimental phase in 12 departments, as of 2006.

Every financial unit (Hôtels des finances) shall have a single service center whose service offering shall be extended with the purpose of solving all major user needs without the need for additional formalities.

The role to be played by user services shall no longer be limited to guidance and general information functions, as in most cases currently.

The service offering proposed in these centers shall be extended so that users may solve most of the most usual inquiries and formalities – handing tax information or forms, grievances or extension requests, payment terms or questions relative to bank debiting.

The financial cost of this transaction is estimated at 60 million Euros.

1.4 Professionalization of the Activity – Competency Hubs.

Many of the small structures lack the necessary size to undertake certain highly specialized tasks under normal conditions. The creation of competency hubs is aimed at ensuring better service continuity.

Specialization within the competency hub enables enhanced efficacy of the services provided and improved quality, adjusting geographical coverage of the units within the national territory to users' actual needs.

1.4.1 Implementation.

The competency hubs are divided into three areas:

- Enrolment Hubs (*Enregistremen).*[2]

Some of the work of the tax administration is closely linked to specific issues of the civil and corporate law fields. The small structures lack the critical size necessary to undertake highly specialized work under normal conditions. Gathering officials in competency hubs will enable enhanced service to the user.

- Control – Expertise Hubs (*Contrôles-Expertise*),

The Control and Expertise Inspectorate (*Inspection de Contrôle et d'expertise* -ICE) is responsible for auditing professionals' files, scheduling, field investigations, disputes and certain complex issues. It is not responsible for current service, nor for recording or following up on obligations returns, which tasks have been entrusted to the SIEs from now on (see 1.2.2). ICE hubs allow for better distribution of knowledge and information, greater availability of competencies, more professionalization and improved efficiency.

- Enforced Collection Hubs (*Recouvrement forcé*)

The collection function is highly atomized, both from the geographical and functional perspectives. There are more than 850 services implementing different procedures at varying frequencies. Most collection services perform enforced collection actions on few occasions and, when they do, they lack the expertise required to achieve an efficient outcome, and necessary support on the matter. In turn, as regards enterprises, this situation does not favor equal treatment.

The creation of a competency hub, understood as a dedicated service for the treatment of cases calling for more cumbersome or complex actions

[2] In French tax terminology, the term *enrolment* (« enregistrement ») means both a publicity formality opposable to third parties, and a tax.

aims at solving these inconveniences and ensuring a proximity service coupled with the highest quality collection actions.

Thanks to the consolidation of technical competencies and better coordination and centralization of actions, the enforced collection function assures a quality improvement.

1.4.2 Generalization.

The different structural reforms shall be implemented progressively until 2008.

1.5 Means Available to the Tax Administration to Combat Tax Fraud: Regional Intervention Groups.

The 29 Regional Intervention Groups (GIR as per the acronym in French), scattered across the national territory, were created in 2002 with the purpose of grouping the staffs of the different government services in fighting crime and the underground economy in all their varieties.

These groups are made up of organization and command units (UOC as per the acronym in French) which are a sort of general staff of the groups.

The UOCs are permanent structures where functions are performed by police officers, coast guard police officers, customs and DGI officials (one per UOC).

Most of these officers come from the investigation or inspection services of the DGI, which ensures high sensitivity in field operations and information searches. In general, they carry out their functions in police or coast guard police headquarters.

The function of Organization and Command Units basically consists in gathering information in the framework of legal actions or prior stages to determine objectives. While carrying out this task, tax officials keep their fiscal prerogatives. That is why GIRs are particularly active in combating small and medium crimes, in particular in connection with stolen goods and narcotics trafficking.

2. ADJUSTING THE TOOLS

Users may choose the channel (telephone, Internet, mail) they wish to use to contact the administration and obtain the service desired, in absolute certainty that their interaction shall be secure and respect individual rights and freedoms.

2.1 The *Copernic* Information System.

The *Copernic* system, launched in 2001, has the purpose of establishing a single new tax IT system shared by the DGI and the DGCP. Based on the notion of a tax account, this system enables the solution to limitations in the current tax IT systems. Its full implementation is expected for late 2009. The major objective of this system is contributing to progressive modernization and improving the tax administration's performance in the framework of the performance contracts[3] signed by the DGI and the DGCP – currently for the 2006-2008 period.

2.1.1 The tax portal: "www.impôts.gouv.fr"

The "www.impôts.gouv.fr" website has been available for Internet users since March 2001 and enables online access to all tax documentation. Subscribed users, both corporations and individuals, have the added possibility of querying their tax account and paying their taxes by secure transactions.

2.1.2 An online tax account for individuals

The principle ruling the tax account notion is simple: providing taxpayers with a complete picture of their tax status (income tax return queries, tax notices – income tax, generic social contribution (SCG), contribution for the refund of the principal and subordinate social debt (CRDS), land tax – and information regarding payment modalities (monthly installments, banking debit).

There are currently 46 million online accounts which users may access at any time.

[3] Contractualizing objectives and resources between the directorates and the Minister

In 2005, 2,510,718 users queried their tax account on the Internet, and 1,060,878 electronic payments were made on the following taxes: income tax, real estate tax, land tax and generic social contribution.

Likewise, online income tax returns have been increasingly successful in recent years (in 2005, 3.4 million taxpayers chose to report their income over the Internet).

In 2006, the IT application was configured to absorb 10 million online returns.

2.1.3 An online tax account for professionals.

The service offering is similar to that available for individuals, with secure access to the tax account, the returns service and remote payment of VAT and online tax payments management on a 7x24 basis.

Effective since February 2005, the 3.8 million professional users may access their tax account over the Internet to make online transactions by means of a unique ID obtained upon receiving a certificate and a mandatory subscription.

In the future, the certificate will no longer be required. By accessing the impôt.gouv.fr website located in the public area of the tax portal, users will be able to query the tax administration through an electronic form (“formuel”) which shall be automatically redirected to the competent administration.

2.1.4 Internet payments.

2.1.4.1 For individuals

The online payment system allows users to issue a payment order for their taxes at any time they wish, until the due date indicated on the tax notice, with the advantage that the payment is only debited 5 days after the due date. With this payment modality, individuals have an additional 5-day term after the due date to make an online payment of income tax, real estate tax, the tax on audiovisual services, land tax, social contributions and the tax on vacant homes. Direct online payments are not made through a banking card but by a very simple debit formula.

2.1.4.2 For Professionals

Also through the www.impôts.gouv.fr website, the TéléTVA service enables online VAT return submission and payment. The online payment application “Satelit” enables corporate tax and economic activity tax payments.

The téléTVA@ service became operational in April 2001. To access it, users must first purchase a digital certificate and subscribe to the remote services. With this modality, professionals may file returns and make payments of VAT online, by means of the EDI (Electronic Data Interchange) procedure.

There is an additional service which enables remote VAT return submission and payment based on the exchange of files formatted as per the EDIFACT (Electronic Data Transmission for Administration, Commerce and Transport) standard.

Currently, 55 % of VAT payments are made over the Internet (80 billion Euros since 1 January 2005 and 34 billion Euros in the way of remote tax payments by corporations, in addition to VAT).

A Few Figures on the Télé TV@ Service

- 172,164 corporations adhered to the télétv@ service in 2005,
- 995,530 returns were filed over the Internet
- 550,350 payments were made remotely.

These remote payments represent an amount of 80.5 billion Euros.

2.1.5 The restructuring of the collection system.

Tax collection within the sphere of the *Copernic* system represents a financial flow of 250 billion Euros per year.

There are currently numerous highly diversified and poorly articulated IT applications.

This heterogeneity stands in the way of:

- Having a full picture of the collection status, both at the level of the DGI and the DGCP,

- Managing taxpayers' financial positions globally.

At present, a single collection application is being developed, which shall be used by both DGI and DGCP officials.

2.2 Improving User Relations.

2.2.1 Invitation to Regularize Delinquency.

This friendly notice addressed at individuals was first implemented in 2005. Comparable to a regularization of the income return, it is issued during the stage prior to control operations of documentary evidence per se.

This friendly notice, arising from rapid detection of the most obvious income differences, has the purpose of favoring voluntary compliance with tax formalities and obligations by taxpayers and helping to provide better treatment to those who regularize their situation *bona fide*.

In the framework of this procedure, the French Tax Administration provides taxpayers with the income return elements held by the administration and proposes an off-court regularization.

In effect, taxpayers responding favorably benefit from a 20%[4] relief and a pardon on the interest on arrears. The State thus collects taxes owed sooner.

At the national level, off-court invitations to regularize situations account for 940,000 files.

2.2.2 Other significant administrative innovations: the pre-filled return.

The success of the pilot test carried out by the DGI in 2005 for the implementation of a pre-filled tax return led French ministers to decide to generalize this benefit for all taxpayers as from 2006.

In the framework of the modernization of tax functions, the use of a pre-filled return form is a considerable step forward for all Frenchmen. In this pre-filled return aimed at assessing income tax, the tax administration states

[4] This relief is exclusively applied to remuneration and wages reported spontaneously.

the taxpayer's data which it already holds in the areas of wages, remuneration and pensions. This translates into a significant simplification for users with simple incomes (e.g.: pensioners). Taxpayers continue to be fully liable for the content of their returns, which they must either confirm or correct, as the case may be.

The outcome of the pilot test conducted in 2005 in Ille et Vilaine showed a very low correction percentage of around 12%.

This action is expected to have an impact at the budgetary level as well, since the prior use of information received by third party reporters (employers, etc.) shall limit reporting fraud on a *de facto* basis.

3. MANAGEMENT CONTROL ENABLES ASSURANCE OF THESE INNOVATIONS

In the framework of the performance contract signed for the 2006-2008 period, the General Tax Directorate and the Public Accounts Directorate reaffirm their will to place users at the heart of their concerns.

Establishing simpler taxation which allows users to fully enjoy their rights as soon as possible is a strong bet. This concern has the corollary of more responsiveness vis-à-vis delinquency and reporting non-compliance.

3.1 Simplified Taxation.

The DGI and the DGCP have undertaken a quality improvement process for the services provided to users.

The commitments accepted in this connection by virtue of the program "Making Taxes Easy" – one of the core themes of the Letter to Taxpayers – shall continue to be assessed on a regular and homogenous basis in the two networks, by means of internal audits and external evaluations.

The nine common commitments between the two networks are:

- All telephone calls shall be followed up,
- Inquiries by mail shall be replied within 30 days,
- E-mail inquiries shall be replied within 48 hours,
- Services shall be available daily,
- Appointments made shall be respected,
- Confidential reception,

- Officials' identification,
- Telephone inquiries shall be dealt with,
- Forms shall be sent within 48 hours,
- Information regarding the tax mediator.

On the other hand, the DGI and the DGCP undertake, from now until the end of the contract, to obtain certification by an independent external body of at least 200 units. Certified services shall observe a demanding set of common guidelines, prepared based on existing guidelines.

3.2 Allowing Users to Fully Enjoy their Rights as soon as Possible.

The DGI is committed to awarding users the possibility of fully enjoying their rights as soon as possible.

The table below shows the percentage of VAT credit refunds and balances in favor of taxpayers owing to excess payments on corporate tax which received a favorable or partially favorable response within 30 days or sooner.

2005	2006	2007	2008
80 %	80 %	80 %	80 %

Percentage of legal claims on income tax and real estate tax dealt with in a one-month period.

	2006	2007	2008
Income Tax	94 %	94 %	95 %
Real Estate Tax	95 %	95 %	96 %

In case of disputes on jurisdictional matters, the DGI commits to promptly respond to taxpayers' petitions. The DGI's commitment, which in the past was limited to administrative jurisdictions only, has extended to include legal jurisdictions. In addition, performance shall be measured by indicators which shall contemplate not only the cases filed during the year but also the existing legal cases as at 31 December.

3.3 More thorough Knowledge of the Tax Population.

In the scope of the contract mentioned, significant progress has been made to render information relative to taxpayers' censuses increasingly reliable.

For the upcoming period:

- The commitment of ensuring more reliable individual user identification has extended to file information on real estate tax;
- The quality of professionals' identification shall be maintained (compatibility rate between DGI and INSEE-identified professionals equal or higher than 98%).

3.4 More Responsiveness vis-à-vis Delinquency and Reporting Non-compliance.

The DGI shall continue to organize itself to maintain a high responsiveness vis-à-vis reporting non-compliance and delinquent situations. This step is necessary to ensure good overall results at the tax administration level and to benefit taxpayers: failure to respond promptly in cases of reporting non-compliance or the accumulation of tax debts might lead to an unfavorable spiral for taxpayers.

3.4.1 Objectives regarding reporting obligations:

Percentage of professional users who meet their VAT reporting obligations within the legal periods.

2005	2006	2007	2008
86 %	88.5 %	89 %	90 %

Percentage of delinquency in terms of submission of corporate annual Profit (or Loss) Returns

2005	2006	2007	2008
< 2 %	< 1.2 %	< 1.1 %	< 1 %

Percentage of users who meet their obligations on Income Tax.

2005	2006	2007	2008
97.8 %	97.8 %	97.9 %	98.0 %

3.4.2 Objectives relative to payment obligations:

Enforced collection centers for the most complex debts shall be generalized. This formula, as shown by the results of the pilot test, shall allow for increased efficacy of the function (collection volume, relevance of legal steps, efficiency gains).

Percentage of taxes paid spontaneously to the DGI *(to date, the calculation focused on VAT; into the future, the indicator also includes corporate tax and wage tax)*

2006	**2007**	**2008**
98 a 98.5 %	98 a 98.5 %	98 a 98.5 %

Net Percentage of Enforced Collection
(the scope of the indicator extended to corporate tax and wage tax).

2006	**2007**	**2008**
55. 0 %	55.25 %	55.50 %

CONCLUSION

The DGI shall assess the resources used and the results obtained from actions aimed at raising tax awareness among individuals and professionals and combating tax fraud. The Letter to the Taxpayer, issued in late 2005, recaps every citizen's rights and duties.

This letter shall be updated on a regular basis and its remembrance shall be assessed.

Indeed, tax awareness assumes a responsible and personalized relationship between citizens and officials: simplicity, respect and equity shall orient the work of the administration.

The administration has the duty to act equitably and respect individuals' and citizens' rights. In exchange, French taxpayers shall be loyal and cooperative.

One of the most significant challenges facing the French tax administration lies in making life simpler for taxpayers/citizens: tax performance is, in effect, largely secondary to the spontaneous acceptance of taxes.

Case study

TOPIC 2.1

ADMINISTRATIVE INNOVATION AS A WAY OF GUARANTEEING TAX RESOURCES

Hans van der Vlist[1]
General Deputy Director
Dutch Tax and Customs Administration
(The Netherlands)

1. INTRODUCTION

At the end of 2002, the Board of the Dutch Tax and Customs Administration concluded that major changes in the Procurement and Collection processes were needed. The current processes cannot cope with the changes of a rapidly changing society. The Information and Communication Technology (ICT) systems supporting the processes are over 30 years old, expensive and inflexible. Because of this, the people working within the collection processes are not supported by the ICT systems in differentiating between good and bad taxpayers, between low- and high-financial risks.

[1] Speech given by Mister Peter Jongkind, Tax and Customs Administration Products and Processes Development Program Director, in representation of Mister van der Vlist.

An efficient, risk-driven approach is impossible in this situation. Former attempts to replace the supporting ICT systems by new ones were not successful. Reasons for these failures, among others, were:

- the approach was problem and ICT driven, and not business driven;
- scope, complexity and manageability were underestimated;
- too many innovations took place at once; and
- there was lack of adequate research and feasibility studies.

To address these issues, a new business-driven strategy is being applied to modernize the collection processes and to improve the ICT support. This change program started at the end of 2001 and is currently being configured using software from SPL WorldGroup Inc. (the Customer Care and Billing Solution). CC&B is expected to be fully operational in July 2007.

The overall approach in the change program which was used during the last two years is new in different aspects. The main phases of this approach are:

- realizing an overall change program and small realization projects;
- development of business strategy, vision and business goals;
- development of a modernized and simplified business process;
- realization of quick wins to improve the business results at short notice;
- development of a business case to predict the results of the quick wins and the future processes; and
- selection of an ICT market solution to support the new processes for the next 15-20 years.

2. THE TWO-WAY PROJECT STRATEGY

First of all, the approach was business-driven. We started the business approach by focusing on developments and trends in the outside world. We looked at how businesses such as banks, telephone, and utility-companies are organizing their collection processes.

We started with developing a vision and business strategy. Next we designed the necessary processes after which we looked for the appropriate ICT-support.

We developed the vision and business strategy in a relatively short time (3 months). This turned out to be a great success and we were able to achieve concrete project results in three-months time. This helped establish a very positive image of the program.

We, likewise, developed a two-way strategy: quick wins as short-term results, and a long-term approach for those subjects that needed time and fundamental research. This strategy was very successful. Putting enough effort in the first stages of the long-term solutions, like the question on how to replace the ICT system, was effective. In the past, we tended to jump to conclusions because of a real or presumed lack of time. This time, we heavily invested in the preliminary phases, which in the end resulted in a much faster and better outcome at much lower cost.

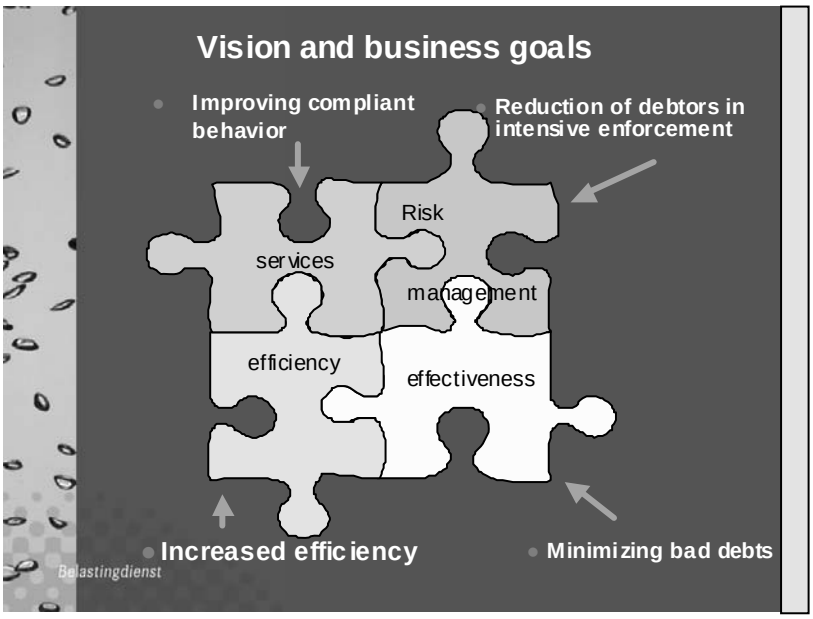
It is our prevailing project management style to create large, fully self-supporting project groups that function outside the operational level. The disadvantages of this approach are inflexible and ineffective procedures and the risk of low quality products with low customer acceptance. But for this project, our core team was composed of only eight people, from different professional backgrounds: business- and process architects, communication experts, collection specialists and a program manager. This is another basic aspect we applied in the new project approach. We have chosen to engage a small core team but required maximum involvement and commitment from people in the operational level (people from the collection processes) as well as top management. The project-members responsible in achieving the quick wins were all working in the collection processes and participated part-time in this project. Thus we created a large, flexible workforce who committed themselves to creating their own future work-processes. Thanks to those “quick wins”, the employees involved in collection processes saw concrete results which helped them perform better and get themselves committed to the project.

We also invested in communication for effective dissemination and exchange of information among and between all employees working in the collection processes. A mix of communication instruments was used: articles in the corporate magazines; the intranet and the most popular one being the roadshow of members of the core team in all regional offices where they explained the vision, results and plans of the project.

To commit top management to the project, there was regular contact with the program management where they were not only informed, but also made to participate in some of the activities.

3. BUSINESS STRATEGY

The business strategy of the Dutch Tax and Customs Administration is summarized on the figure below and is founded on the succeeding principles:



Improving compliant behavior

In the case of first offenders, the policy is to use the “soft” approach in collection and be service-oriented. People who do not pay their taxes for the first time will receive a reminder for payment without the usual penalty. If they, then, cannot pay their taxes, this reminder of payment gives them the option to contact the new collection call centre to discuss alternative payment solutions such as deferred payment or terms payment agreement. The tax payer is responsible for this contact.

Goals:

- Decrease the numbers of summons by 1.2 million in 2007.
- Increase payments received by • 230 million in 2007, from payment agreements.

Reduction of debtors in enforced collection

Based on a profiling process, an early distinction is made between compliant and high-risk taxpayers. The approach used here consists of an effective and efficient risk control in order to minimize the risk of bad debts from high-risk taxpayers.

Goals:

- Reduction of warrants by 50% in 2007.
- Profiling support for all employees in 2007.

Increased efficiency

To increase efficiency, processes are standardized and programmed to the maximum extent possible.

Goals:

- Reduction of the process duration by 15 days for low-risk and 30 days for high-risk taxpayers in 2007.
- Percentage of continuous payments at 75% in 2007.
- Warrants sent by mail in 2007.
- Standard and routine measures in enforced collection for all assessments less than • 3000 in 2007.

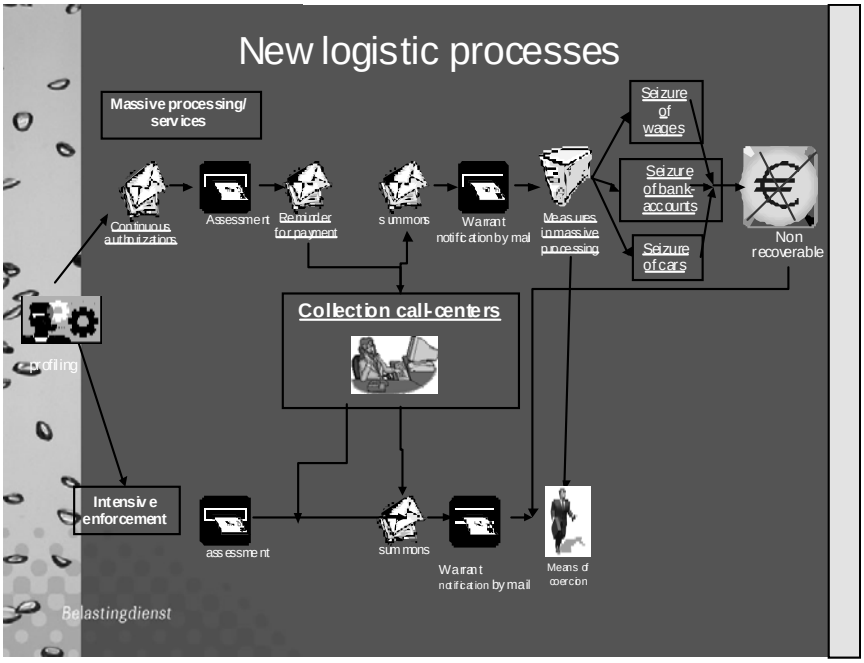
Reducing bad debts

Goals:

- Reduction of warrants by almost 50% in 2007.
- Reduction of cases requiring means of coercion for collection by 50%.
- Predictable collection per measurement.

The business strategy helped to generate a model of the new processes based on the vision. In this model all elements mentioned above found their place in a logical sequence. We used this model as an instrument to communicate with both the top level management as well as the workforce.

The model was also the basis for the development of the new business architecture (see Chapter 4).



4. BUSINESS ARCHITECTURE

The business architecture serves as a profound and relatively stable basis for business process redesign. This business process redesign is used to define the functional requirements in selecting an IT-solution for the collection processes.

Based on the business strategy, a business architecture which describes the future collection and disbursement processes on a macro level was developed. In this model the main functions are defined as follows:

Debtor's position assessment, including:

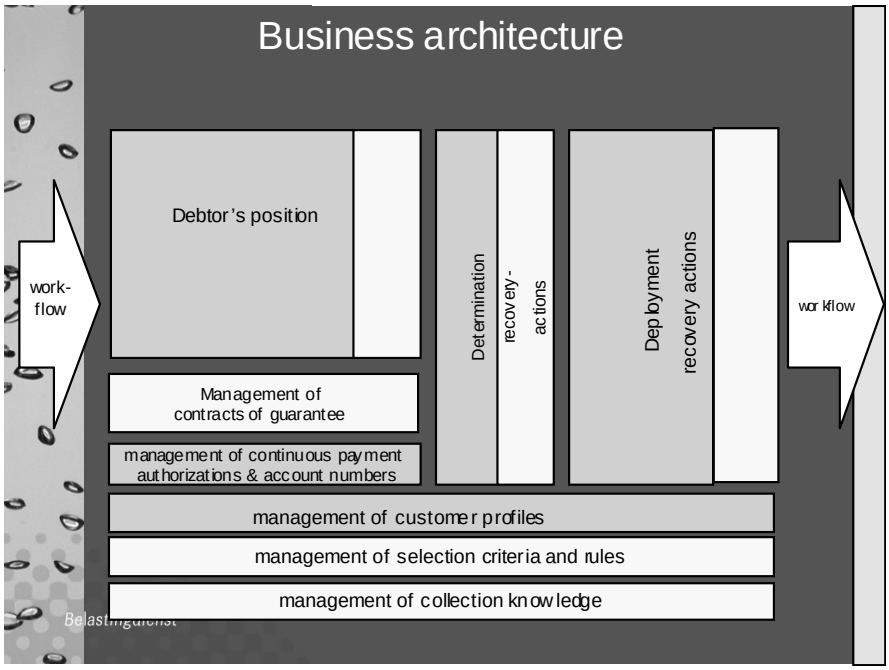
- Revenue accounting.
- Deferral.
- Discharge / remission.
- Appeals.

Determination of recovery actions, including:

- Risk management

Deployment of recovery actions, including:

- Reminders of payment, summons, warrants.
- Collection by means of coercion.
- Write-off policy on bad debts.
- Contracts of guarantee management.
- Continuous payment authorization & account numbers management.
- Customer profiles and selection criteria management.



We learned from the past that very detailed specifications in this phase of the project or the pursuit of total compliance of descriptions are major risks. To avoid falling into the risk-traps, we designed the business architecture using the following guidelines:

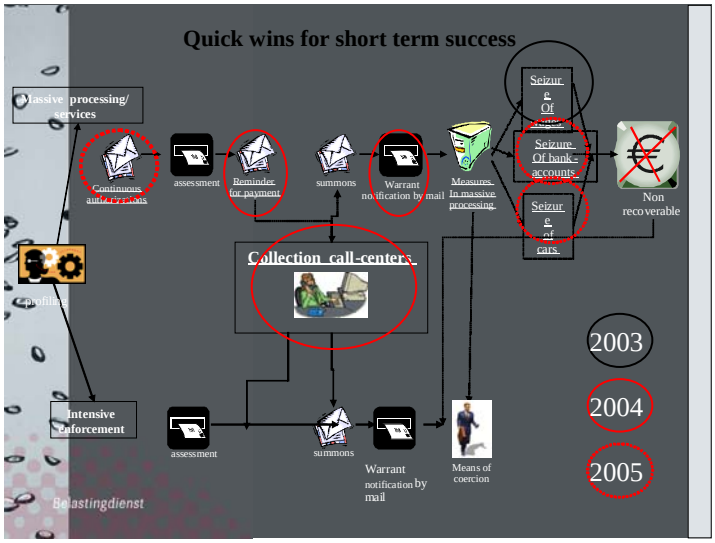
- Processes described on a macro level.
- Functional requirements (regardless of the current organizational structure).
- Processes defined in terms of workload.
- Process-types and performance indicators.

5. QUICK WINS FOR SHORT-TERM SUCCESS

Knowing that the fulfilment of the business vision and strategy cannot be realized before 2007/2008, the project team developed short-term alternatives with the following characteristics:

- supporting the vision,
- improvement in terms of the new processes,
- realizing at least some of the business goals,
- running on the current ICT-systems.

The decision to implement the quick wins was taken at the end of the year 2002. The first results were already implemented in October 2003 and January 2004. One benefit of the quick wins is, as previously stated, that it helped to bring about commitment from the people working within the collection processes.



The quick wins are:

On continuous payments. A study was done to find out the possibilities for a system of continuous payments; the effects in terms of euros received; and the willingness of the taxpayers to use the continuous payments system. Also the support of the present ICT-system was investigated. Due to the lack of functionality of the present ICT system, implementation is expected to begin in 2007/2008, together with the introduction of the new ICT system.

Reminder for payment. A study showed that the *reminder for payment* system can be carried out within the possibilities of the current ICT system. The changes to that system were done in April 2004; the implementation was in January 2005.

Collection call centres. This solution also turned out to be possible within the present ICT and telephone support capability. Implementation was also done in January 2005 in addition to the reminder for payment.

Sending warrants by mail looked simple from a technical point of view. The real problems had to do with politics. In the early nineties a similar proposal was disapproved by the Dutch parliament, and implementing this now needed a legislative change. Nevertheless, the result of this major effort was that parliament approved the new law in December 2003 and the implementation was completed successfully in January 2004.

The instrument needed for *seizure of wages* for those taxpayers, who even after receiving a warrant still do not pay, was successfully implemented in October 2003.

Studies for the possibilities to use *seizure of bank accounts* and *seizure of cars* were completed in March 2004. Although in these cases the law also has to be changed, implementation started in July 2005.

With these results, not all the objectives mentioned in the business vision were realized. A new ICT-system was required to fully realize these objectives.

6. BUSINESS CASE

Using a business case methodology, we calculated the effects of the quick wins and the realization of the entire vision after the implementation of a new ICT system in terms of the business goals mentioned earlier. The calculated results were quite spectacular in terms of:

- Increased compliant behaviour.
- By sending reminders of payment the numbers of summons is expected to decrease by 1.2 million (from 3.2 to 2.0); the number of warrants by 0.5 million (from 1.6 to 1.1). This effect will even be stronger after the introduction of continuous payments in 2008.

Increased efficiency

The process duration will be reduced from 112 to 70 days for compliant taxpayers and 50 days for non-compliant taxpayers. Due to this, the number of warrants will go down by 0.2 million (from 1.1 to 0.9). The financial benefit from this is estimated at • 103 million paid five weeks earlier. Also, the number of employees in the collection processes can be reduced by 210 (from 1500). After the introduction of the new ICT-system the number of employees will further decrease by 160. In addition, the process duration will decrease by 10 more days.

Reduced bad debts

The financial impact of contacts via the call centres is an additional collection of •350 million a year, attributable to payment agreements.

Reduce the number of taxpayers in enforced collection

The volume of collection by means of coercion will be reduced from 0.60 to 0.35 million. The volume of bad debts will go down from 0.40 to 0.20 million a year.

Business results

Reduction of employees in intensive enforcement	Efficiency
Assessments : 3,2 -> 2,0 million. Warrants : 1,6 -> 0,9 m. Means of coercion : 0,6 -> 0,4 m.	Duration time : - 50 days Less employees : - 370
Reduction of bad debts	**Compliant behavior**
Call centres: 300k settlements (€350 million.) < bad debts: €75 million. Payment acceleration: €150 million. (annual interest €2,2 milliion)	Summons decrease: 1.2 million

In terms of payments received projection, the effect of the entire operation will be a one-time revenue of • 160 million, and • 110 million in annual revenues. Initial investments amount to • 44 million and • 9 million structural investments per year.

7. SELECTION OF AN ICT MARKET SOLUTION

Make or Buy?

As mentioned in chapter 4, we decided to limit the amount of detail in the process redesign. Main argument for this decision was to conform to best practices and create certain 'degrees of freedom' in changing the business processes to match the IT-solution. This increases the opportunity of finding a market solution for our new ICT system.

In 2003, we asked 2 independent consultancy companies to perform a market scan for ICT-solutions, suitable for our situation.

The first result was overwhelming: more than 2000 possible solutions were identified. In order to narrow the choices, we developed the so called 'knock-out' criteria: if a vendor solution does not meet any one of the criteria, the solution no longer becomes an option for us. Thus we managed to reduce the number of solutions from 2000 to 11 in an effective and efficient way.

From long list to short list: defining KO-criteria

Knock-out criteria:
- Specific business criteria:
  - Required functionality (global)
  - Required work load
- Generic criteria:
  - Availability of reference sites
  - Vendor marketleadership
  - Data accessibilty ('open' architecture)
  - 'open' workflowmanagement
  - 'out-of-the-box' implementation
  - Alignment package purpose and business processes
  - Concentrated datamanagement and browser-based

As a next step, we analysed the fit of the solution packages with our newly developed collection processes. Almost all essential functions in the new processes were supported properly by the packages. A similar analysis on the possibility to re-use (parts of) the old ICT systems showed that re-utilisation was not a realistic option.

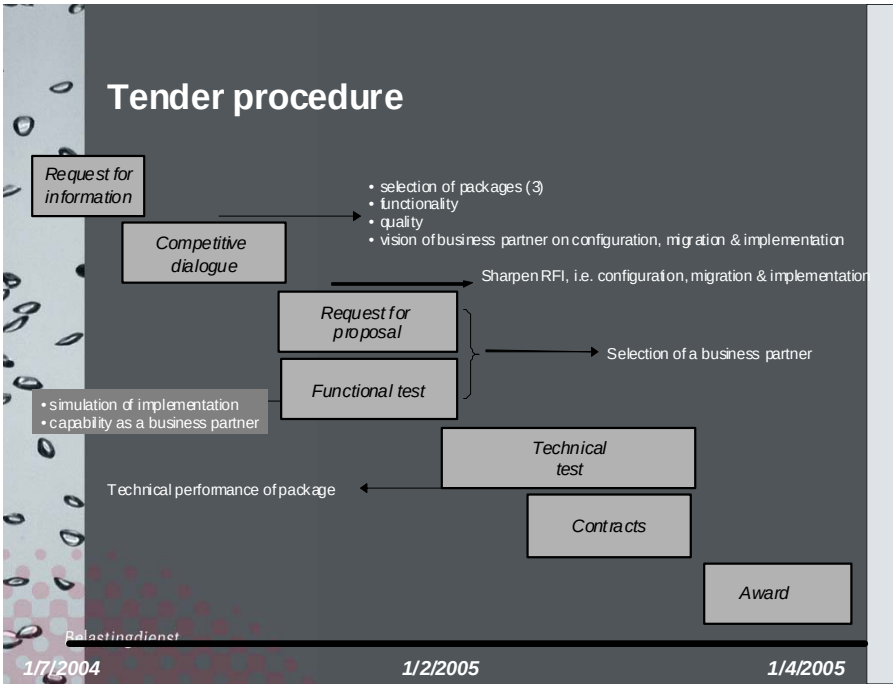
Tender procedure

Based on these results, the Board of the Dutch Tax and Customs Administration decided to start a European Tender Procedure in December 2003. In May 2005, the tender procedure ended and SPL WorldGroup Inc. was chosen. The work has started and we are now aiming at July 2007 for the start of implementation of the new collection system.

Also thanks to new regulations because it was possible to adopt a new tender procedure, the so called competitive dialogue. The problem we had with the old tender procedures was that it was completely paper-driven; you had to make your decision based purely on the written answers by the ICT vendors to your questions. What we liked about this new procedure was getting an impression of the willingness of the vendors to be a real business-partner and their capability to implement our processes (configuration) in their system. We also favored parts of this configured system being tested by our end-users, as a part of the tender procedure.

This resulted in the following revisions in the procedure:

- Request for information, from which we selected the best three packages;
- Competitive dialogue with three vendors to help us select the best business-partner;
- A functional test of the ability of the vendors to configure their system concluding with an end-user test;
- Request for proposals, in which the vendors had to present their final proposal for delivery plans, configuration and migration plans, as well as quality and functionality of the package;
- Technical test, in which performance of the system on our technical infrastructure is measured;
- Contract negotiations and award.



The figure above illustrates the chronology of events in the tender procedure we used in selecting the ICT solution we needed for this project.

ANNEX

EXPLANATORY NOTES ON THE DUTCH POLICY ON COLLECTING TAX

Policy of the Dutch Tax and Customs Administration

In the tax collection process (i.e. from the issuing of a tax assessment to the payment of the tax due), the Tax Administration's primary aim is to encourage people to pay voluntarily.

If people fail to pay and the Tax Administration takes coercive collection measures, it adopts a risk-oriented approach. This means that the available capacity is used to obtain the maximum return. In addition, the process is designed in such a way that all debtors are reached (equality before the law).

Risk-oriented approach

The Dutch Tax Administration's policy is supported by a risk-oriented model. The model involves two stages.

In the first stage, a distinction is drawn between good, less good and bad taxpayers. In what is known as the risk model, scorecard methodology and objective data are used to calculate a 'score' for each debtor, indicating the likelihood that they will settle their debts within a year. These scores are not based on subjective assumptions, but calculated yearly with the aid of an econometric model. In the second stage, the scores are used as one of the main variables in selecting the most effective measures. This selection process is supported by a modern computer system. Other variables used, besides the scores referred to above, include the nature and size of the tax claim and the debtor's payment record. A payment record is measured using a points system, in which points are awarded and deducted for positive and negative behaviour respectively.

As a result of this approach, customers receive differentiated treatment based on fixed and objective risk profiles.

Customer management and the risk-oriented approach

Policy is directed at ensuring that the group of voluntary taxpayers is made or remains as large as possible. The measures that underpin this policy are, almost without exception, carried out by computer or computer-assisted. The Tax Administration's approach to this group is characterized by helpfulness and goodwill. Examples of the measures it uses include: accessible information on the deferral and remission of tax debts, low-threshold deferral possibilities (simply requesting deferral by telephone), payment reminders with no extra charge, a high level of service for direct debit, discounts for payment in advance, and collection by telephone.

The approach adopted towards problem taxpayers is characterized by efficiency and a focus on securing a maximum return, without detracting from important principles of administration such as equality before the law. For the private individuals in this group, the process is designed in such a way that the coercive measures selected are dealt with or largely supported by the computer system. Failure to pay after a writ of execution has been served (by post), as a rule, triggers an enforced collection procedure. This means that the tax owed is debited from the debtor's bank account on the initiative of the Tax Administration. The procedure is fully computerized. If the bank balance is insufficient, debits from the account are blocked for a week. If such a procedure is not possible, the debt is recovered by means of an enforced deduction from the debtor's wages or social security benefit. This procedure is also largely computerized.

For private individuals in the group of problem payers from whom it is difficult to recover tax claims, measures are also available that address the tax liability itself. For example, people who persistently fail to pay motor vehicle tax can have their vehicle registration refused and in practice be prevented from owning a car. This is a way of ensuring in due course that no new tax liabilities arise, and remain unpaid.

In the case of problem business taxpayers (legal persons and natural persons), the sums of money involved are usually large. In addition, considerations of fair competition also have a bearing on collection policy in this area. This is reflected in the Tax Administration's policy in that payment by business taxpayers may not be deferred unless sufficient security is provided.

The policy is designed to prevent debts mounting up. Assets are seized within six weeks of it having been established that a tax assessment has not been paid. Property seized is sold no more than four months later.

Besides taking possession of property, the Tax Administration may petition to have the debtor declared bankrupt as a way of enforcing payment. The Tax Administration's new computer system not only supports the selection of the most effective collection measures (sort of seizure, petition for bankruptcy), but also supports their implementation, by means of the advanced production/compilation of, e.g. bailiff's forms and files.

Misuse and payment fraud

Misuse and payment fraud are combated in the area of collection by means of extensive legislation on the liability of third parties. It relates partly to strict liability and partly to general liability. In the former case, the simple fact that a third party (e.g. a company that has hired temporary staff) can be linked to an instance of misuse is sufficient to establish liability. In the latter case, the third party must be shown to have behaved in a culpable manner in relation to the misuse. In many cases the burden of proof has been shifted to the advantage of the Tax Administration.

In practice, liability legislation primarily has a preventive effect. One of the most recent measures in this area was directed against the infamous VAT carousel fraud. Following the introduction of legislation on liability in this regard in January 2002, the phenomenon has become virtually unknown in the Netherlands. It should be pointed out, however, that it has unfortunately moved to other EU countries.

Case study

TOPIC 2.2

COMPLIANCE CONTROL

Luis Pedroche y Rojo [1]
General Director
State Agency of Tax Administration - AEAT
(Spain)

CONTENTS: 1. Introduction.- 2.- The General Organizational Framework Model for Tax Examination Applied to Spanish Taxpayers.- 3. Planning in the Struggle to Counter Tax Fraud.- 4. Tax Fraud Prevention Plan.- 5. AEAT Proposals as to International Tax Fraud Mechanisms.- 6. International Cooperation .

1. INTRODUCTION

There are two ineluctable aspects in the achievement of the financial objectives inherent to the role of tax administrations. On the one hand, to favor compliance with tax obligations for all kinds of taxpayers who are willing to meet their payments and, on the other, to set the largest number of hurdles to intentional noncompliance, for which modern tax administrations avail themselves of strong control mechanisms, the effectiveness of which determines, at least to a certain extent, the system's credibility.

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[1] Paper presented by Mr. Carlos Herrera Álvarez, Responsible of the International Relations Unit of the State Agency of Tax Administration of Spain, on behalf of Mr. Pedroche y Rojo.

This second aspect, compliance control, is faced with not only the reluctance of the least cooperative social group, but also the use by this group of means to attain their ends that are as state-of-the-art as those available to tax administrations for the furtherance of their functions, in the context of economies marked by globalization, across-the-board IT implementation and protection of taxpayers' rights, not always implemented to the benefit of those who deserve to be defined as such.

The purpose of this presentation is to analyze, however briefly, the actions from the State Agency of Tax Administration (AEAT, acronym in Spanish) in response to the increasing number of fraud strategies, which are no longer individual, homemade actions but financial projects designed by International Tax Law experts, broadly implemented on a professional basis.

Any modern tax policy must therefore pursue two aims: a) to improve the use of risk analysis instruments to correctly identify fraud centers, and b) to foster streamlined control, searching for the fastest response available to counter tax avoidance schemes.

The objective is to attain appropriate control to reduce the time gap between fraud strategies and their potential control to the greatest possible extent, by means of actions that create and foster general awareness in the sense that the struggle against fraud is on the right track.

There is an increasingly widespread belief that said track goes in line with the implementation of a broad approach on the issue, which is only attainable by cooperation from all government agencies, both national and international, involved in efforts to detect and counter fraud.

This presentation shall analyze the current standing of tax compliance control measures within the Spanish Tax Administration. It is worth pointing out the three parts in the contents hereof, which will serve as a guide from the current AEAT status to the latest tax fraud prevention propositions:

A) The general organizational framework model for tax examination applied to Spanish taxpayers.

B) Inspection planning instruments and, specifically, the Annual Tax Examination Plan.

C) Integration of overall measures to counter tax fraud that make up the Tax Fraud Prevention Plan.

D) AEAT proposals as to international fiscal avoidance schemes.

E) International tax control cooperation.

2. THE GENERAL ORGANIZATIONAL FRAMEWORK MODEL FOR TAX EXAMINATION APPLIED TO SPANISH TAXPAYERS

a) Legal Basis.

The purpose of this section is not to delve on the legal basis for tax examination in Spain, but to define the essential structure that, within the Rule of Law, guarantees and legitimates the performance of the Spanish Government Tax Administration Agency (AEAT, as per the Spanish acronym).

The Spanish Constitution of 1978 provides for the common contribution to support government spending within a fair and equitable tax system. It is obvious that a vital condition to ensure fairness is that Government shall avail itself of coercive means to guarantee that the tax burden be distributed among taxpayers, even if they avoid voluntary payment.

In line with this constitutional mandate, the recently enacted General Tax Act[2] (LGT, by its Spanish acronym) superseded the General Tax Act of 1963 as the core legislation for tax enforcement. The latter was in force for a long period and was subject to a number of amendments, which attests to the strong grounds as to tax relations in our country from pre-constitutional times.

In this regard, the LGT covers the legal nature of administrative actions for examination matters, enabling the Finance Ministry in Article 5 as the competent authority on tax enforcement and the imposition of penalties, insofar as this is not expressly authorized by law to a different public law agency or institution. Article 5 sets forth that such powers be attributed to the AEAT, in the terms defined in the General Tax Act. This norm[3] defines the Government Tax Administration Agency as the administrative organization in charge of, for and on behalf of the State, the effective enforcement of the state tax and customs system, with the duty of carrying out the administrative actions required for the enforcement of the tax system

[2] Act Nº 58/2003, December 17th.

[3] Act Nº 37/1990, December 27th, State General Budgets.

on a broad and effective basis for all taxpayers, through the management, oversight and collection procedures in place.

The LGT amendment is geared at adapting the base tax norm to the current fiscal system's requirements, incorporating the essential changes stemming from a set of regulations that ensure taxpayers' rights and guarantees while they endorse the new methods to counter tax fraud.

Therefore, the AEAT is the competent authority, vested with the legal powers to enforce the state tax system and control mechanisms.

b) General Control Framework.

The AEAT operates on the basis of the Spanish general administrative model, which is based on the principles of hierarchy, decentralization and coordination. The AEAT structure enables competencies vis-à-vis control actions to be clearly defined but, at the same time, requires the existence of a number of instruments to guarantee cooperation from the different agencies and thus ensure administrative efficacy.

Tax examination design and planning competencies in the Spanish system are distributed among four Departments, of equal hierarchy and which report, in turn, to the AEAT Office of the Director General: the Tax Management Department, the Tax Inspection Department, the Tax Collection Department and the Customs and Special Taxes Department. The first two share tax examination tasks relative to the main taxes in the system (direct taxation through Income Tax for Individuals and Corporate Tax; indirect taxation through Value Added Tax); the Department of Customs and Special Taxes performs all the examination functions on customs duties and specific taxes, while the Collection Department manages the coercive collection efforts for all tax revenue and other tax claims as provided by public law.

The Office of the Director General of these Departments is based in Madrid. Given the territorial decentralization that marks the Spanish organizational model, tax examination enforcement is performed by the newly created Central Delegation for Large Taxpayers,[4] the Special Delegations (one for every Autonomous Community), the Finance Ministry Delegations (at least

[4] Decree EHA/3230/2005, dated October 13th, by virtue of which the Central Delegation for Large Taxpayers and the Office of the Assistant Director- General of IT and Fraud Investigation in the Tax IT Department are created within the Government Tax Administration Agency.

one for every province) and the Finance Ministry Tax Administrations (in large cities that are not provincial capitals, which coexist with the Delegations in the largest cities). This Department-based organization is replicated in Delegations and Tax Administrations, with the same hierarchical system within every Autonomous Community.

The AEAT tax examination structure entails four distinct categories of taxpayers:

- Large taxpayers, individuals as well as corporations, determined pursuant to their income or business volume.
- Businesspeople, individuals or corporations, and professionals, both under the direct assessment regime.
- Small and medium size enterprises under the objective assessment regime.
- Individuals who do not undertake business or professional activities.

The assignment to one group or the other not only defines formal obligations by which taxpayers are bound, but also determines the type of examinations to be conducted and the agency in charge of them, as analyzed hereunder.

1) Large Taxpayers, Individuals as well as Corporations, defined according to their Income or Business Volume.

For certain taxpayers who, given their income or business volume, exceed the normal examination possibilities of delegations and inspection offices, a system has been foreseen, which may be defined as a continuous examination system, by assigning said taxpayers to the Regional Inspection Offices or, in the case of key economic players, to the Central Delegation for Large Taxpayers.

The criterion to determine the assignment to one examination body or the other differs qualitatively as well as quantitatively. In general terms, taxpayers with an income of over six million Euros (7.2 million dollars approximately) within a fiscal year shall be automatically assigned to the Regional Inspection

[5] Decision dated March 24th, 1992, from the Government Tax Administration Agency, pursuant to the organization and assignment of functions to the Tax Inspection Office in the framework of the competencies of the Financial and Tax Inspection Department.

Office[5] in the following fiscal year. This office is in charge of performing all the management procedures (through the Regional Offices for Large Enterprises) and tax examinations, which grants a specific and individual treatment of the tax administration procedure, in the broad sense, applicable for the 32,000 businesses currently registered.

In the case of entities with a business volume in excess of one hundred million Euros (one hundred and twenty million Dollars approximately) or with over ten thousand returns filed to the Tax Administration, they shall be automatically assigned to the Central Delegation for Large Taxpayers, which is also in charge of tax administration of taxpayers who, given their economic relevance or the complexity required to control them, are assigned to the Central Delegation based on a Decision by the Department of Organization, Planning and Institutional Relations.

Both groups of entities bear a significant effect on revenue, their contribution to Government Revenue has accounted for 64% of the overall tax revenue collected by the AEAT in 2005, excluding revenue from customs duties and indirect taxes paid off at Customs.

The Central Delegation is fully competent and performs all the functions inherent in the Tax Agency as to the enforcement of the state and customs system for all taxpayers assigned thereto; it thus encompasses the management, inspection and collection tasks, except for customs duties' and Special Taxes' processing.

Therefore, the goal is to improve efficacy and fairness in the treatment of large taxpayers, by a better integration among inspectors from the inspection and customs areas, thus strengthening the coordination among the assessment and collection areas. The creation of the Central Delegation implies that procedures from the beginning of tax examinations not only be aimed at overcoming tax noncompliance, but also ensuring effective collection of the potential debts assessed.

The modification of the organizational structure set forth is aimed at reducing the indirect tax burden affecting taxpayers with a large volume of operations, and therefore, tax obligations. In this regard, the Revenue Agency offers the possibility of relating to a single body, in which they shall be able to complete most of their filing requirements, with individual assistance that shall facilitate compliance with tax burdens.

From the functional standpoint, the proposal by the Revenue Agency seeks to accommodate the organic distribution of administrative offices to the

financial conditions it is faced with. In doing so, and given the concentration of taxpayers with corporate domiciles in Madrid and Barcelona (with 200 and 108 groups in 2005, which represents, respectively, 73.7% of the overall number), the administrative structure is adapted to this characteristic.

2) Other Taxpayers, Individuals or Corporations, with Business Activities under the Direct Assessment Regime.

This category encompasses all the individuals or corporations that conduct business or professional activities, which, excluded from the objective assessment regime, feature an annual volume of less than six million Euros. Their legal nature determines the tax category they are subject to: individual business owners shall file Income Tax Returns for individuals under the direct assessment regime, regular or simplified; approximately 1,400,000 taxpayers fall into this category, while Corporations shall file Corporate Tax Returns, also under the direct assessment regime, and they represent approximately 1,100,000 returns on an annual basis.

For this group of taxpayers, the regular tax examination system applies, which differentiates the extensive compliance control for tax liabilities, conducted by the Tax Management Offices, from the in-depth examination of taxpayers, a competency of Inspection Offices.

At least a brief reference should be made to the essential features of the Spanish tax control system in Spain. The principle of administrative decentralization, in order to come closer to taxpayers, renders the Special Delegations the competent authorities to develop management and inspection examinations. Regional Offices, which report to the Special Delegation in each autonomous community, perform examination tasks under a similar organizational structure to that of the Tax Agency.

Therefore, the Management Office performs administrative functions, as regards examinations, of refunds' control, verification of the source of tax benefits, control over appropriate compliance with filing obligations and invoicing, and lastly, conducting limited examination procedures.

The latter, limited examination procedures, have been clarified in Article 136 of the LGT, which enables management offices to examine records and other documents required by tax legislation, but not accounting records' information, which is to be analyzed by the inspection offices. The management powers include examination of invoices that serve as warrant for the transactions included in said records, and the use of records in the

assessment process, including the possibility of requiring general information from third parties; requirement of financial transactions records is beyond their scope.

In the case of extensive taxpayers' examination actions, marked by blanket requirements from the management offices, selective examination is conducted by the Inspection Offices, which are in charge of the in-depth examination of taxpayer tax status.

Tax Inspection Offices are vested with the highest competencies vis-à-vis tax examination initiatives, without any limitations other than those stemming from territorial jurisdiction or functional jurisdiction and as provided by legislation, among which we must highlight the Taxpayers' Rights and Guarantees Act[6], given its practical incidence, and the regulations thereof.

It therefore stands to reason that inspection competencies be focused on the investigation of the assumptions as to noncompliance with tax liabilities and filing requirements; likewise it also spans efforts to collect information from third parties, examination over securities' ownership and tax assessments that stem from examination actions. Tax Inspection Offices are, in turn, in charge of rendering information to taxpayers based on inspection procedures as to their tax rights and liabilities and consulting and reporting to other Government Administration agencies.

For the purpose of performing its functions, the Tax Inspection Office is enabled to examine the main and ancillary accounting practices of taxpayers as well as all the other records and documents deemed relevant for tax purposes, especially digital databases, records and files relative to financial transactions.

Only officials who perform inspections may visit businesses and other sites where taxable activities are conducted. For said purposes, the Inspection Office does not require a court order, although should access be banned, an administrative authorization is in fact required.

It must be finally pointed out that these officials are vested with enforcement powers and must receive the necessary protection and assistance from public authorities for the purpose of the appropriate and free performance of their inspection duties.

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[6] Act Nº 1/1998, dated February 26th.

Once the examination actions are finished, it is the role of the Collection Department, and specifically and based on the decentralized structure, the Regional Offices, to implement coercive collection actions for tax liabilities, as governed by public law, whether of a tax nature or not, without a court order being required. The link to all the Revenue Agency information systems is the key factor to ensure adequate collection management, on a voluntary as well as coercive basis.

3) Small and Medium Sized Businesses under the Objective Assessment Regime[7]

The objective assessment regime foreseen in the Spanish tax legislation applies to certain business activities conducted by individuals with an annual business volume under 450,000 Euros (approximately 540,000 Dollars). It is a voluntary regime geared at taxation based on benchmark indexes and not the business net returns, calculated from the accounting income on the records.

Currently, the number of business owners under the objective assessment system or assessment by modules amounts to 1,800,000.

This is a method to simplify registration and invoicing requirements for small businesses, and thus reduce the indirect fiscal pressure, enabling on the other hand, that the Administration's examination activity be conducted by verifying certain parameters without the complexity entailed by accounting analyses and the payment and collection systems in place.

In line with this layout, the Management Office is in charge of examination of all the stages in the business process of this category of taxpayers, conducting management functions over returns filed as well as blanket and selective examinations over taxpayers.

The Management Office conducts an automatic blanket examination of all the returns filed by taxpayers. Additionally, their competencies are extensive to controls over certain taxpayers selected from a process based on risk analysis techniques, according to a series of data that was crossed, information gathered from taxpayer returns as well as those filed by third parties.

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[7] Provided for in Articles 29 of the TRLIRPF (Amended Income Tax for Individuals Act), 30 to 37 of Royal Order Nº 214/1999 and Decree Nº-HAC/3718/2005, dated November 28th, 2005, which sets forth the instructions, indexes and modules for 2006.

Spanish tax legislation empowers management offices to conduct a limited examination process for these taxpayers, except for the examination of accounting records, of third-party requirements to gather new information and investigation actions outside the offices of the authority of jurisdiction, save for those relative to enforcement of objective taxation methods.

Therefore, the Management Offices conduct a comprehensive review of individual business owners who apply for the simplified tax regime, which includes filing returns up to verification of parameters on which their tax payments are based.

4) Individuals who do not conduct Business Activities.

This category includes taxpayers subject to file Individual Income Taxes (IRPF, by the Spanish acronym), with income originating from wages or return on investment in securities and real property.

This may be deemed the sector towards which most of the tax reforms have been geared in the last decade, most likely owing to the quantitative relevance, the revenue capacity and the number of returns for this category of taxpayers.

With the purpose of reducing the number of taxpayers with mandatory filing requirements, and thus, reducing indirect fiscal pressure for workers and investors, we have pursued the enhancement of withholdings' mechanisms so that, at the end of the tax period, the amounts withheld practically match the net payment installment that stems from the tax assessment.

Evidently, this system releases a significant number of resources in the Tax Agency, since the management offices are in charge of carrying out all the actions on this group. Formally speaking, the tax examination framework is identical to the one in place for those who perform business activities under the direct assessment regime: filing returns and undergoing extensive and limited examinations conducted by the Management Department; in-depth examinations conducted by the Inspection Department.

The collection of the IRPF-revenue relies by almost 90% on these taxpayers through the system of retentions on wage and equity income; nevertheless, control thereof, although it involves a large number of returns, does not entail any special technical complexity. Therefore, management offices assume those examination actions with the support from two basic pillars of the Spanish tax system, the IT software development to simplify extensive

examinations as to tax liability compliance and the application of these tools to data treatment, which, by means of tax returns, are received by the Tax Agency.

The few in-depth inspections of the tax status for these taxpayers are focused on those with special complexity or greater financial relevance.

3. PLANNING IN THE STRUGGLE TO COUNTER TAX FRAUD

Thus, we reach the strategic key tax examination aspects in the Spanish system. Information gathering processes are based not only in the recording of any data provided by taxpayers in the tax returns they file, but also a complex information-gathering system that affects the regular obligations required by law for banking institutions and public officials, as well as any other individual or corporation in the course of their business relations with third parties.

Certain figures may provide a clearer view of the relevance of information-gathering mechanisms for the Tax Agency: with a population of around forty four million inhabitants in 2005, there is information relative to 41,400,000 taxpayers, out of which 4,400,000 are business owners; overall, the agency handles approximately three billion records, around 72 per every taxpayer.

This volume of information may only receive proper treatment with a powerful IT system in place. The development of IT for tax purposes has been the core pillar for the efforts by the Spanish Tax Administration in the last two decades, and this strategic commitment has enabled the creation of specific tools for information treatment and risk analysis that guarantees the proper enforcement of the whole system and development of further examination plans in the efforts to counter fraud.

The decision as to which taxpayers ought to be subject to tax examination is one of the key elements in the Spanish tax system overall. Essentially, taxpayers are selected based on meeting certain criteria that stem from complex selection tools, which cross relevant information and alert on the existence of tax inconsistencies that may lead to assuming that a tax violation has been committed.

Therefore, the system is based on decisions from individual data that stem from a series of IT information sharing that are considered relevant according to experience in the area, given their financial importance or the risk of

fraud. But, on the other hand, concrete actions are grounded on an annual examination policy, which defines what business sectors or type of taxpayers or taxable activities call for priority consideration.

The General Tax Examination Plan is the instrument by which the actions to be conducted by the offices of the Revenue Agency are defined vis-à-vis tax and customs examination. The Plan identifies the areas, sectors and transactions that shall be subject to examination, as well as the methods and procedures applicable, all in line with the general strategy to counter fraud.

The current system integrates within a single plan, the previous Objectives' Plan (which determined the expected assessment and revenue) and the Examination Plan itself (determining what should be inspected, the sectors or parameters that called for priority attention).

The General Plan differentiates, on a structural basis, a number of general guidelines, partial examination plans and certain integration standards for these partial plans.

The general guidelines describe the main areas for tax risk and the lines of action deemed a priority in each one of the areas on which the Plan is based.

Partial examination plans are of a specific nature for each one of the areas with examination functions (Financial and Tax Inspection Office, Customs and Special Taxes, Management and Revenue), and include an extensive development of the procedures and activities to be performed in each one of them, with a detailed explanation of the quantitative and qualitative forecast of the programs and type of actions to be met during the year, broken down according to organizational structure and geographical area.

The Annual Tax Examination Plan provides for a series of standards to integrate partial plans, which span the coordination and cooperation measures and procedures among areas, aimed at achieving control over the actions to be carried out by offices from different areas.

The drafting of the Annual Plan is a role of the Office of the Assistant Director-General of Planning in each Department, which drafts the section that applies to their specific functional area. Taking into account the possibility that there may be objectives difficult to align, the Office of the Assistant Director-General for Organization and Coordination, within the Department of Organization, Planning and Institutional Relations, integrates the plans

from all Departments, adjusting the final outcome to the objectives and priorities of economic policy and efforts to counter fraud that may guide the performance of the Revenue Agency in that period, which are evidenced in the general guidelines of the Plan overall.

Centralization into a single Department thus aims at guaranteeing an overall and consistent vision of the General Examination Plan and facilitating follow up efforts of the objectives set forth therein.

4. TAX FRAUD PREVENTION PLAN

The creation of a strategy aimed at preventing tax fraud necessarily affects the examination offices and procedures in place, since it calls for adjusting to the new tax avoidance schemes that any prevention plan wishes to counter.

Notwithstanding, a change in the substance of the above mentioned examination program is not foreseen; the same system shall continue in place, based on the systematic use of information sharing practices for risk analysis and different treatment according to the group of taxpayers entailed.

In this regard, we must point out that, in general terms, the measures adopted by the Plan may be further developed with the current means and procedures, which facilitates one of their objectives, enforcement in the middle term.

a) Plan Drafting.

The Tax Fraud Prevention Plan, drafted by the Spanish Revenue Agency and disclosed in February of 2005, is based on the need of improving the efficacy in the prevention of tax noncompliance.

The Plan is the answer, in any case, to the claim of our citizens, expressed in taxpayers' perception as to the two main aspects of tax management: while in 2004, 82.8% of citizens were satisfied or very satisfied with the service rendered by the Tax Agency, slightly over 42% expressed their satisfaction with the effective actions of the Agency in the efforts undertaken to counter tax fraud.[8]

[8] Study by the CIS on Public Opinion and Tax Policy, 2004.

Additional significant data worth mentioning are: 24 % of Spanish citizens believe there is great tax fraud, while only 13 % considers that in Spain there is little or very little tax fraud. The majority, 63%, believes there is tax fraud to a large extent.

It is worth highlighting that not only it is vital to face the struggle against voluntary noncompliance given the loss of public revenue it entails, which inevitably turns out in a greater fiscal pressure for compliant taxpayers, but also the relevance of the social perception of fraud in the latter's view. Therefore, the purpose is to avoid opinions that tend to discourage voluntary compliance that may end up disseminating noncompliance behaviors.

The Plan was drafted according to a methodology, which if not deemed radically innovative, succeeded in introducing social participation elements that were inexistent in previous plans. On the other hand, this is a global strategic plan to be developed and enforced in the middle term, and therefore, different from specific annual plans, or the last general survey, conducted in 1996 by the Biannual Plan to Counter Tax Fraud, which was limited to the tax sphere.

The Plan is based on a two-level structure: the first one, global, which sets forth the correction of structural issues and defines basic principles for action; the second one, geared at listing specific actions, entails defining specific measures pursuant to the issue of different types of fraud.

The Plan incorporates an overall review of the Tax Agency's system of objectives, with a view to implementing an operational plan to guide the decisions of the Agency itself.

This proposal is supplemented with an enforcement calendar, which defines certain priority measures and designates specific responsible parties to enforce and allocate resources for the development thereof.

The Plan was drafted pursuant to the following steps:

- Underlining the Weaknesses in the Organization:

    a. Problems that relate to information gathering and systematization of the data collected by the Tax Agency: a large volume of tax information is available, but there are difficulties in making an efficient use thereof, especially in the real estate sector, which complicates the process of selecting taxpayers eligible for examination and the enforcement of examination actions themselves.

b. Attaching priority to taxpayers' information and assistance services as to fraud prevention strategies, lacking a significant undertaking to foster social cooperation from citizens or an external communication policy to enhance the effects of examination efforts.

c. Undefined policies to counter fraud in certain sectors, such as the real estate sector, or certain phenomena such as money laundering or VAT organized schemes, which occur internationally.

d. Improper use by certain taxpayers of the objective tax assessment regimes, sometimes used as a means for fraud by diverting benefits or issuing fake invoices.

e. Organizational model and external alliances with little flexibility in the Revenue Agency from its onset, which has impaired its capacity to respond to phenomena such as taxpayers who move their business, or business operations in tax havens.

f. Absence of a clear and comprehensive strategy in the face of the increasingly frequent fraud during the collection phase of tax examinations, which entails fraudster businesses that drain the company of its cash, availing themselves of the examination period to conceal their assets and hurdle collection of the tax liability assessed on the examination records.

g. Lack of coordination in certain VAT examination procedures as to fraud in the area of Customs and Special Taxes, which are carried out by different offices, which prevents a comprehensive examination of related tax bases.

h. Limited scope of procedures' planning and defining objectives to be met by the parties involved against in-depth examinations, geared at examining a small number of taxpayers and disclosing a certain debt amount, with a discouraging effect on more complex investigation tasks.

- Expert Analysis:

The Tax Agency Director's Office set forth, for each one of the measures, an expert in charge of the study thereof, who was tasked with submitting a report and proposal bearing a diagnosis of the situation, improvement

suggestions and a calendar to develop the measures, as well the appointment of the enforcement Departments or Services.

The person responsible for each study was free to gather information on the subject and consult with the different services involved in the area under study. These reports and proposals were finally submitted for consideration to the Agency's Departments and Services and, upon ratification by the Permanent Steering Committee, became the basic literature on which the Fraud Prevention Plan would be grounded.

- Plan Draft:

Once the experts' proposals were received, they required systematization and coordination. Over sixty reports were received and thus consolidated into eleven blocks, either by fraud modality, type of taxpayer involved or type of measure proposed.

- Public Information:

Maybe one of the most unprecedented aspects was that of setting forth the Plan to a public information proceeding. Over 500 individual suggestions were received and twenty-two reports by professional associations, unions or professional colleges; the Tax Agency undertook the analysis of all the information, which contributed to the improvement of the content of the Plan and to focus it on citizens' claims vis-à-vis tax fraud prevention.

It is the Agency's intention that the Plan be open to citizens, for which purpose there is a suggestion box on their Web page www.agenciatributaria.es. Thus, citizens who wish to do so may enter their own proposals and comments, and the Tax Agency promises to review it on a regular basis and incorporate the relevant ones in future plans.

b) Enforcement Areas.

Without attempting a specific analysis of the measures adopted by the Plan, all of them may be grouped into three main enforcement areas:

1) Information, Preventive Procedures and Institutional Alliances:

   - Tax Education and External Communication: The interest in reinforcing tax awareness of citizens recommends conducting tax education programs and institutional communication

measures that favor voluntary compliance and deter fraudulent behavior.

- Information for Examination Purposes: The Tax Agency features a powerful IT system and large volumes of information, not always appropriately organized. Maybe the most relevant case is the real estate sector, in which the information overall is fragmented and incomplete.

- Memoranda of Understanding: With the same purpose of enhancing social cooperation in the effort to counter fraud, the adoption of Memoranda of Understanding is foreseen with business and professional associations, as a form of commitment in providing relevant information to prevent fraud or assuming a code of ethics or good fiscal practices. Cooperation should be understood from two aspects, social interest groups must reap benefits from their business activities, either directly or indirectly, which may imply the need for the Agency to enhance the prestige and image that stem from subscribing the Memoranda.

- Institutional Alliances: The Plan foresees strengthening of Tax Agency relations with other Tax administrations, especially those in the autonomous communities, and other agencies and institutions (Land Registry, Ministries, Judicial Branch, and Registries).

2) Special Priority Areas:

One of the most relevant priorities of the Plan is focused on the international organized fraud schemes, which is addressed in greater detail hereunder. The other special priority areas analyzed in the Plan are:

- Real Estate Sector: The most frequent types of fraud consist in concealment of asset ownership, transfers filed for smaller amounts, and concealment of revenue stemming from real estate transactions, especially leases.

- Customs and Special Taxes Fraud: This is the area in which measures are developed to counter the most serious fraud schemes with recent incidence in terms of foreign trade and

money laundering stemming from drug trafficking, activities that call for immediate action by the Tax Administration.

- Small and Medium Sized Businesses: The fundamental issue in this sector is the improper use of objective tax assessment regimes, which play a significant role in simplifying formal obligations that small business owners are required to meet and facilitate tax system management by the Administration, which are abused by certain taxpayers in some cases.

- Tax Engineering: In the cases of sophisticated fraud that employs tax engineering formulas, abusive tax planning and irregular businesses, the complexity of examination proceedings require the implementation of a procedure that enables to manage the available information and knowledge, and guarantee their use in the examination procedures, in order to detect similar cases and standardize the actions to be carried out to counter this type of fraud.

- Fraud in the Revenue Collection Phase: Given the increasing response from taxpayers subjected to examination with actions to avoid collection of assessed liability (draining of company cash, involving insolvent third party individuals or entities to hurdle allocation of responsibilities), the Plan sets forth an action program based on the enhancement of current coordination efforts among the assessment offices and collection agencies, defining a number of risk criteria that suggest the ongoing control of certain taxpayers to guarantee collection of liabilities.

3) Operational and Organizational Measures:

In line with the creation of the Central Delegation for Large Taxpayers, the Plan assumes the need of reorganizing the Agency itself and empowering certain areas, with the purpose of attaining an overall system to counter fraud.

This is the goal pursued by the creation of the National Office for Fraud Investigation (ONIF, by the Spanish acronym), which horizontally integrates the two previous offices that reported to the Department of Inspection and the Department of Customs and Special Taxes. The idea is, that based on the systematic use of techniques specialized in the detection and planning of actions against the most serious cases of fraud,

overall, preventive and punitive plans may be put in place, specifically designed for every type of fraud discovered, with the support of the Department of Tax IT to develop new applications.

One of the most significant operational measures is aimed at enhancing non-tax aspects, but the integration of other Government areas interested in the struggle against illegal activities; in order to attain this, increased collaboration is expected from the Government Law Enforcement and Security Forces, considering that the law that creates the Tax Agency foresees a law enforcement unit to assist in the services rendered by the Agency, as to investigation and countering of fraud.

An Agreement was deemed the appropriate instrument to improve coordination between the Attorney General and the Tax Agency to define the role that the latter's Legal Affairs Department plays in the criminal pursuit of fraud, as the criminal agency of jurisdiction as to crimes against the Public Tax Administration.

It also highlights, as a measure of organization, the adoption of a regionalized tax control model, which entails the commissioning of units with a broader territorial jurisdiction that are specialized in certain economic sectors, regardless of the provincial or local units that, although vested with regional powers, may devote their effort preferably to examination of taxpayers' in their original venues.

A final remark on the Plan and its operation: the Tax Agency considers this Tax Fraud Prevention Plan as a social commitment with citizens, which entails the need to perform ongoing control thereof within the Agency itself as a means to provide citizens with the information required regarding compliance, keeping a permanent contact with political parties in Parliament for them to know in detail the general operation of the Tax Agency and the outcomes attained by the Plan.

Notwithstanding, the proposal does not include a request for more material resources. The Plan's objective is to increase efficacy in the use of available resources without entailing a higher cost. This forces the Agency to reallocate resources and pursue the most efficient organizational structures to meet the objectives vested upon it. Likewise, it shall be necessary to divert human and material resources devoted to administrative and support tasks to others more directly linked to tax obligations' compliance control. In any case, the development of more complex tasks and attainment of fraud control and prevention objectives by the Agency are elements to be considered in the human resources

policy of the institution, the means of which shall be aligned with the objectives set forth, which implies, in turn, relying on a system of compensations and incentives that contribute to the achievement thereof. A system based on results is in line with the improvement of productivity in our country, set forth as a strategic line of government action.

As regards Plan enforcement effectiveness, in the year 2005 and beginning of 2006, we have begun the execution of obligations assumed in the development of the measures approved, even when it is too soon for a full assessment of the outcomes achieved.

5. AEAT PROPOSALS AS TO INTERNATIONAL TAX FRAUD MECHANISMS

In line with the ruling principles of the Fraud Prevention Plan, the economic and social globalization process calls for special attention as to the fraudulent mechanisms regarding three fundamental aspects: a) VAT and Special Taxes organized fraud schemes in transactions within the EU; b) International Tax engineering and Fraud; c) Foreign trade fraud.

a) VAT and Special Taxes Organized Fraud Schemes in Transactions within the EU.

The increasingly borderless nature of countries within the EU has brought about organized fraud schemes, the launch pad for which is the exemption applicable to delivery of goods within the community, which enables their entry into destination countries without paying VAT in the source country.

Very briefly, VAT fraud mechanisms in transactions within the EU operate via holding companies that are set up with the purpose of perpetrating tax fraud on Tax installments that have been duly offset but not paid.

There are numerous modalities as to these fraudulent actions. Perhaps the most typical variation occurs when there is no other activity but that appearing on the records, thus closing the economic loop in the alleged country of origin of the goods, which is why it is known as *carrousel fraud*.

This type of fraud becomes increasingly evident and frequent in certain sectors: mostly alcoholic beverages, second-hand vehicles, IT or mobile telephony.

In spite of how small the scheme is, reality is in fact extraordinarily complex. Their detection involves a number of functional areas from the Tax Agency, the Public Prosecutor and the Judiciary. Nevertheless, the issue not only affects the Spanish Administration, but extends to all the EU Member States, in the framework of a highly harmonized tax. The situation comes to worse in the face of the recent incorporation into the European Union of ten new Member States.

In this regard, the preventive measures geared at organized VAT schemes are a priority within the Plan. Undoubtedly, the maximum efficacy of the actions to counter said schemes is achieved when they are neutralized, an objective only achievable via preventive measures.

Maybe the fundamental reason is the setting forth of a strict control over the European Union Operators' Registry (ROI, by the Spanish acronym), considering that the exemption from the country of origin is not obtained if the operator from the Member State from which the purchase is made lacks a European Union Operators' Registry Number.

The objective shall then be preventing access to fraudsters. For an effective control, it shall be performed shortly after access to the ROI is granted, by a visit to the operator's premises without previous notice, with the purpose of verifying whether the business and operations exist, with the power to impose the precautionary removal from the ROI should circumstances warrant it.

Controls shall be made also applicable on future occasions to avoid the incorporation of fraud mechanisms in the so-called dormant corporations, entities which, without an apparent business activity, wait during periods of inactivity or simulated business activity until the time comes to participate in a scheme while meeting all the formal requirements.

Jointly with preventive measures, the struggle against VAT fraud schemes must be geared at early detection, prosecution thereafter, even criminal prosecution, and recovery of the amounts due.

The procedures for detection of fraud within the shortest possible term rely on the key element of the systematic treatment of the large volume of information available, which shall guide authorities to pursue the selection procedures until they unveil fraud schemes. In this regard, it is important to develop specific IT tools for selection purposes, and to achieve systematic use thereof.

Since information is fundamental, the growing number of international requirements and transactions, followed by proper control procedures, should contribute to facilitating early detection of fraud.

Along with the proposals as to fraud prevention and detection, prosecution of fraud once perpetrated is not attainable through a single procedure. Indeed, the Administration has the power to enhance coordination, once again, with the Public Prosecutor, the Judicial Branch and the Government Security and Law Enforcement Agencies, to achieve the best possible efficacy.

A favorable circumstance that should be leveraged is that the refund of the installments is a function of the Tax Agency, even when the overall refunds are concealed under the blanket process of annual refunds. Although in formal terms there is no reason to argue a refund, a comprehensive treatment of all economic operators may assist in reaching individuals who, beyond name holders and nominee corporations, are the economic beneficiaries of the business operation, and that experience gained through the years proves that they typically participate in this type of operations.

In order to achieve satisfactory compliance of all these measures, a single and centralized strategy that spans all the Agency areas is required, covering from preventive actions to possible coordination measures with other countries, as well as the development of an effective external communication system of the outcomes achieved.

Thus, the Plan foresees that all actions be conducted under the supervision of a highly specialized office, the National Fraud Investigation Office. Additionally, a reallocation of resources is pursued to enhance the performance of said Office and, in general terms, the scheme investigation tasks, with the adoption of regulatory changes as necessary, prior review by the competent administrative bodies.

b) International Tax Engineering and Fraud.

Fraud prevention shall face the evolution of fraudsters' behavior, which, in many cases, has shifted from basic and simple fraud schemes to increasingly sophisticated avoidance behavior, usually defined as *tax engineering* or *abusive tax planning.*

The implementation by the Tax Agency of IT-based control procedures, with the systematic use of the information therein, has influenced this change

in fraud behavior, since less complex and unsophisticated noncompliance and fraud are becoming increasingly easy to detect and redress.

The globalization of the economy has encouraged business transactions with tax havens and low taxation territories as a consequence of these abusive tax planning formulas. The Tax Agency shall face this reality by regulatory modifications and others of an organizational and procedural nature, to which we must add, once again, enhanced operating and information exchange among the different States.

As to territories that qualify as tax havens, the measures approved by the Plan, such as the case of VAT organized fraud schemes, are geared at centralizing the coordination of international tax fraud prevention. It is recommended to conduct a systematic control of enforcement of anti-tax haven legislation with regular examination of taxpayers who conduct international business activities, as well as the execution of special inspection plans for entities domiciled in tax havens that earn revenue on Spanish jurisdiction.

Other measures to be studied may entail more stringent legislation to limit the freedom of these entities in undertaking business activities, defining tax domiciles that shall be assumed in Spain when significant assets are held in our country, compelling businesses to apply for a Spanish Tax ID Number when conducting business in our jurisdiction or raising the tax burden on income earned in tax havens by higher tax rates.

Regardless of which territories are defined as tax havens, there are countries with unique tax legislation and preferential tax regimes in which actual taxation and undefined taxation are similar to those of tax havens themselves. The use of low taxation territories is increasingly more frequent in the highly sophisticated international tax planning cases, in which nominee corporations or companies that transfer money from or towards other countries are normally based in said low taxation territories, employing tax havens as venues for corporate headquarters of the holdings designed for tax avoidance purposes.

The measures to counter these abusive tax planning efforts with an incidence in the revenue system in Spain are partly in line with the aforementioned ones to counter tax havens (coordination of actions by the National Fraud Investigation Office (ONIF, by the Spanish acronym), delivery of legitimate information, adoption of stringent legislative measures for fiscal control and taxation), but there are other specific ones, geared at conducting systematic controls to prove the proper enforcement of anti-abuse measures

foreseen in the agreements subscribed with other States as well as the potential enforcement of the beneficial ownership clause as set forth in bilateral agreements.

It is worth highlighting that in general terms, the fraud scheme design is not directly performed by the taxpayer, but by certain organizations or entities that offer the knowledge and tools to third parties to avoid payment and tax examinations, which calls for the Tax Agency's maximum stringency in locating the core of the fraud schemes and enhancing current legislation as to the enforcement of tax liability assumptions.

c) Foreign Trade Fraud.

Customs control is faced with a series of challenges, related not only to the smuggling or money laundering activities known, but to new forms of fraudulent actions developed in recent years. Additionally, it is a sector that generates a remarkable alarm in society, which may be the source of a disincentive as to voluntary compliance by citizens. Therefore, the adoption of expeditious administrative actions is required for control thereof.

The newest measures considered in the Plan are geared at the detection of payment cases with exports of drug remittances entered in Spain, or the discovery of real estate purchases by drug traffickers through nominee corporations, in which drug trafficking goes hand in hand with money laundering crimes. The main control mechanism is the investigation of exports to source countries of drug remittances by companies with inconsistencies between their export volume and business revenue, supported by IT applications based on statistical techniques and information rendered by the Civil Guard on license plates of suspicious vehicles, especially in traffic to and from Africa. Attention is also focused on the importance of following up on the records of the Customs Surveillance Service and court sentences for drug trafficking crimes.

It is also considered that the Tax Agency shall adopt an active role in the struggle against the informal economy that stems from trademark counterfeiting crimes and smuggling of compact disk duplication machines, by means of implementing specific screening processes in Customs for imports with a high risk of being tied to this type of operations, and conducting actions on the field in certain industrial sectors, based on the available information on geographical areas with potential concentration of undeclared economic activities.

6. INTERNATIONAL COOPERATION

Globalization of economic processes and the globalizing phenomenon facilitated by new information technology evidence the need for a new approach towards international tax relations. The times in which a State could control tax relations with its taxpayers internally, on an isolated basis, are gone. International cooperation seems to be the only viable path given the complexity, already analyzed herein, of the new fraud mechanisms and the evolution of international economic and monetary transactions generalized through e-commerce and electronic fund transfers.

Therefore, we must conclude this presentation by making reference to the efforts undertaken in recent years by a number of supranational entities and other States in aspects relative to tax control efforts.

The Inter-American Center of Tax Administrations (CIAT) already relies on an information exchange model, whose manual is being drafted by an ad hoc Working Group.

Within the Jurisdiction of the EU, the new efforts are geared at bridging the gaps in the control systems that have originated suppression of border controls within the EU and full freedom of circulation of individuals, goods, and capital. Along these lines, the most relevant measures underway are:

- The review of the VIES system to improve quality and content of information relative to transactions within the EU, as well as its extension to services rendered within the EU.

- The adoption of a new follow-up system for the movement of goods subject to Special Taxes, called the ECMS.

- Enforcement of a new information exchange system on the payment of interest.

- Review of cooperation and information exchange mechanisms in place, with a view to their improvement and suitability for new technologies.

- Fostering cooperation among tax administrations through specific programs, such as FISCALIS.

Increasing globalization of economic processes and the greater complexity of tax relations upon expansion of the European Union to include twenty five members may give rise to new concerns. Among them, the potential creation of a supranational institution that sees to the practical issues that currently hinder the proper development of tax administration duties.

The World Customs Organization, considering similar objectives, has been directing recent efforts to tax control and international security issues, encouraging the signing of customs cooperation agreements among its Member States.

Outside the scope of the European Union, the OECD is increasingly focusing on tax control issues, with the creation of a working area through the Forum on Tax Administration, which is placing special emphasis in sharing experiences as to the efforts to counter evasion and fraud. Their objectives in this area are also geared at advancing transparency and information exchange among members thereof, as well as the adoption of measures to counter fraud via tax havens and harmful tax practices.

Tax administrations in Anglo-Saxon countries, such as the United States, Canada or Australia, are also developing initiatives in this area. Areas such as abuse of legislation, Tax Fraud schemes involving tax havens or setting forth good practices and behavioral standards for professionals in the tax field are priority issues for Anglo-Saxon authorities.

Therefore, the Fraud Prevention Plan has been created under the framework of this general trend, leveraging the experience gathered by other tax administrations and adapting their best practices to the Spanish Tax System. This line of action assumes the priority objective for the Tax Agency for future years, with a middle term strategy, whose legislative development is already underway, shall improve tax fraud control mechanisms in our country as well as citizens' perception of the efficacy in this regard.

Case study

TOPIC 2.2

COMPLIANCE CONTROL

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CONTENTS: 1. Introduction.- 2. The Mission of Tax Administrations and their Relationship with the Goal of Improving Compliance Levels.- 3. The Principle of Equity and its Relationship with Compliance Control Processes.- 4. Promoting Voluntary Compliance.- 5. Technology as a Means to Exercise Control Powers.- 6. Practical Case of Control Measures in Countries with a Low Compliance Level.

1. INTRODUCTION

I was entrusted with the task of talking in this forum about Compliance Control, which is an interesting exercise to reintroduce an essential issue for any tax administration.

In spite of the intrinsic complexity of this issue, given the large number of factors that have a bearing on it, the greatest difficulty when it comes to analyzing it derives from the diversity of perspectives from which it can be seen, depending on the degree of maturity of societies, their levels of compliance, the characteristics of the tax system, among many others.

Regardless of the fact that the medium-term objective might be the same, no matter what level of compliance a country has, all countries require the design of a compliance control policy that promotes voluntary compliance.

In a high-compliance environment, efforts will be aimed at maintaining that level; the compliance habit is already there, so efforts should be more focused con reducing the possibilities of tax avoidance resulting from a legislation that might not be adequate in certain aspects.

On the other hand, in a low-compliance environment, efforts should be aimed at changing the tax culture, making decisions that can impinge upon large groups and the results of which may spread throughout the entire universe of taxpayers, thus increasing delinquent taxpayers' perception of risk.

2. THE MISSION OF TAX ADMINISTRATIONS AND THEIR RELATIONSHIP WITH THE GOAL OF IMPROVING COMPLIANCE LEVELS

An essential aspect of the mission of tax administrations is exercising compliance control; knowing the factors that have an impact on compliance levels is a key element in the attainment of their mission.

The purpose of all tax administrations is to raise revenues; therefore, the sustained increase in collection should be their strategic direction. What we believe should change from one administration to another is the way in which they try to attain their mission to collect and increase collection in a sustained manner. The way in which each tax administration decides to go about increasing collection will define the difference between the processes the various administrations implement to increase taxpayer compliance.

However, the sustained increase in collection may occur in a scale that does not match the actions taken by the administration, so we can only ascribe part of the increase in collection to the actions of the tax administration. In other words, we can ascribe to the tax administration only the part of the growth in collection that is achieved as a result of the administration's actions to guarantee at least the same level of compliance.

Adequately weighing the portion of the increase that can be ascribed only to economic growth allows tax administrations to bear in mind that it should be their goal to exceed economic growth. Therefore, to evaluate the actual results of the tax administration's actions, it is important to know what portion of the increase in collection is due to an increase in compliance levels resulting from those actions.

The best way to ensure that part of the growth in collection is be explained through variables that can be ascribed to the tax administration's actions is to determine potential collection and set the objective to reduce the gap between that potential collection and the compliance level that can be achieved. Hence the importance that tax administrations use models to estimate the productivity of the main taxes that make up their tax system.

Increasing the compliance level achieved or further closing the above-mentioned gap implies short, medium and long-term efforts in compliance control processes, which should be part of the strategic objectives of tax administrations and of the initiatives, projects and plans of the organization. That is, the administration's efforts should be aligned in order to reduce the gap between the optimum and the actual compliance level. This means that process design, people's skills and the use of technology should aim at improving compliance level.

For us, there are two factors that determine the level of compliance and its consistency in tax administrations over time –institutional performance and technological performance. For compliance to grow steadily, it is necessary to achieve high performance levels in those two factors.

The level of institutional performance represents the tax administration's capacity to meet its short, medium and long-term goals and objectives. This comprises various aspects like society's perception of the organization's efficiency, the skills and attitudes of human resources, organizational culture, the organization's performance in terms of ethics, taxpayers' perception of risk, and the credibility of the institution's leaders, which can allow them to maintain their positions and influence society.

Achieving a high level of institutional performance becomes an organizational leverage factor for it to maximize its resources. It is one way in which the organization can make the most adequate use of intangible factors, like credibility, respect, leadership, etc.

It is important to point out that a high level of institutional performance depends on a high rating in each factor. Thus, an organization with highly skilled and competent human resources but whose leaders are not credible will have a low level of institutional performance. Likewise, an institution whose leaders are credible but whose human resources are incompetent will have a low institutional performance rating.

Achieving a high performance in all the factors that impinge upon the capabilities of the tax administration implies assuming leadership positions in professional spheres that can allow the administration to transcend socially, creating processes that can translate into benefits for society.

To measure institutional performance is, to a large extent, to evaluate perceptions and expectations. It is therefore essential to make those measurements in order to have objective data that can allow us to identify the organization's actual performance level. Opinion surveys and comparisons with similar institutions should be essential planning instruments for tax administrations, so that they can identify institutional strengths and weaknesses.

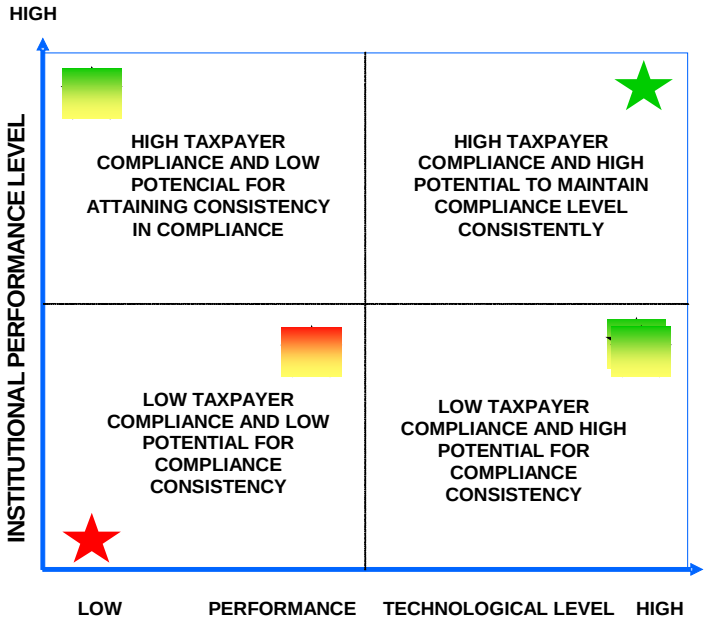
The level of technological performance is understood as the administration's capacity to make use of the technological tools acquired and developed, in line with its strategic objectives. This includes the effective use of technology to improve tax management activities, ensuring compliance with taxpayers' obligations and the return of the investment in the short to medium term.

Technology should become a balancing factor in designing simple and cost-effective processes with sufficient controls to preserve compliance and ensure officials' transparent conduct.

A tool used in strategic analysis to represent the impact that two factors on two axes have in connection with one objective and to determine the level at which the organization stands vis à vis the objective is strategic quadrants.

In this case, we put the two factors just described on the axes of the diagram –Institutional performance level and Technological performance level- and we represented their impact on the level of compliance and its consistency over time.

Note that in the quadrants we have related compliance level consistency with high performance in these two factors; low performance in any of them makes the compliance level achieved not be consistent and, therefore, it would not be feasible to achieve a sustained increase in collection in the medium term. This shows that a high performance in both factors leads not only to an increase in compliance level but also to its sustainability.



Institutions with a high technological performance but with an organization that performs poorly require excessive efforts to increase the compliance level, although, over time, the level achieved is maintained consistently.

Adequately designed and implemented information systems aimed at improving taxpayers' compliance control allow tax administrations to act as a machine in which each component of the process operates in a quasi-automatic mode and exercises some degree of control on the component that comes after it.

When we have institutions with a high level of technological performance but with poor institutional performance, we will not make big leaps in taxpayers' compliance level, but that level will be more or less consistent.

In summary, leaps in compliance levels occur –except for those resulting from reforms in tax regulations- in periods of high institutional performance.

To make important changes or innovation in control processes it is necessary to reach tacit or formal agreements with taxpayers, which can only happen if the administration has a high level of institutional performance. If the tax administration is highly regarded by society, it will manage to introduce law enforcement tools (resolutions or administrative rules) or tighten certain aspects of law enforcement without causing trouble for the incumbent government.

The importance that our analysis attaches to what we have called institutional performance requires that we constantly measure its constituent factors, by means of surveys aimed at measuring taxpayers' and society's perceptions.

Thus, it is important to conduct such studies on a regular basis to compare results and to design action plans that the tax administration should follow to improve the elements that might negatively impact society's perception of the tax administration's capacity to perform its mission.

3. THE PRINCIPLE OF EQUITY AND ITS RELATIONSHIP WITH COMPLIANCE CONTROL PROCESSES

There is a direct relationship between the level of inefficiency of a tax administration in the performance of its control functions and tax evasion levels.

A tax administration that does not implement efficient compliance control processes promotes evasion and, quoting Professor Claudino Pita, "*it represents, of all acts that harm the principle of taxation equity, the most blatant and reprehensible form of taxation injustice*".

When the tax administration does not adequately exercise its examination, revenue-raising and collection powers, the beneficiaries of that incapacity are those that do not comply, while those that do are at a disadvantage. This unequal treatment translates into the violation of the principle of taxation equity.

Lack of equity leads to the loss of credibility in the institution, a reduction in the perception of risk and even doubts about the tax administration's capacity to perform its mission. All that causes a reduction in the level of organizational performance and therefore has a negative impact on the possibility to achieve a sustained increase in collection based on an increase in the general compliance level.

Depending on taxpayers' perceptions of whether the tax administration's actions ensure equity, there will be a greater or lesser predisposition to compliance or non-compliance with tax obligations. Although in no way can the lack of equity be ascribed exclusively to the tax administration's actions, since on many occasions the tax systems themselves, sometimes riddled with inaccuracies and/or exemptions, generate a lack of equity that encourages non-compliance.

It is said that "*it is reasonable to expect good taxation results only when you have good taxes and when those taxes are adequately managed*"[1]. In this sense, there is a direct relationship between the characteristics of the legislation and the strength of the tax administration.

The characteristics of the legislation may facilitate or hinder the tax administration's exercise of its powers. Thus, the tools to implement compliance control processes may vary depending on the legislation.

Each tax legislation defines the scope of the control processes that tax administrations can execute. While some legislations leave significant room for action on the part of the tax administration, others are very focused on guaranteeing rights and put part of the compliance control process in the hands of the courts, forcing tax administrations to make greater efforts to achieve the same results. In other cases, the legislation becomes an obstacle for the achievement of the tax administration's objectives, since it prevents, regulates or excessively restricts access to information or the application of preventive measures on taxpayers' property.

The legislations that provide a very open framework for the execution of enforcement measures or whose provisions are permissive for the organization favor the violation of taxpayers' rights and damage the tax administration's credibility, obviously affecting its institutional performance.

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[1] General Consumption Taxes and Value Added Taxes in Latin American Countries, by Luís Illanes.

Likewise, the definitions contained in Tax Codes in terms of the tax administrations' powers to assess amounts due and conduct audits may have a positive or negative impact on how tax administrations exercise those powers, depending on their scope. Defining the most appropriate scope for those powers should be a relevant issue when talking about exercising compliance control.

Together with the auditing power that the tax administration has, the effectiveness of the enforcement system is one of the essential tools when it comes to ensuring taxpayers' compliance with tax obligations. The perception of risk created by the level of sanctions and the effective enforcement thereof will play a key role when the taxpayer decides whether to comply or not with tax obligations.

However, experience has shown us that the mere repressive nature of a tax system does not determine its effectiveness. If penalties are too severe, they may become inapplicable or, what is even worse, they may favor corruption around them.

Another aspect that is worth stressing is that penalties should serve as a deterrent for taxpayers. If the repressive system is too slow, it loses much of its effectiveness and efficacy. From this perspective and for the system to be more efficient, the tax administration should at all times make sure that auditing and enforcement procedures are fast.

An important aspect of this variable, which is closely related with the equity and justice of the tax system, is the need for taxpayers to note that the application of penalties for non-compliance with tax obligations does not depend on political or economic criteria and that everybody is equally liable to be audited.

On the other hand, many tax administrations, for allegedly efficiency purposes, frequently audit large companies only, which create incentives for small taxpayers to fail to comply with their tax obligations, since they know that there is little probability that they be audited.

Tax administrations should publicize decisions against non-complying taxpayers issued by the Tax Courts or by the administration itself, when they become final. That would encourage taxpayers to meet their obligations for fear not only of being penalized but also of facing social condemnation.

4. PROMOTING VOLUNTARY COMPLIANCE

We are convinced that the most important component in the process of increasing compliance levels is voluntary compliance. Plans to promote voluntary compliance are essential when looking for a way to achieve a sustained increase in collection. Increasing voluntary compliance levels is essential for tax administrations' performance of their mission, and legislation has a determining impact in this regard.

Even if the purpose of this presentation is to refer to tax administrations' compliance control tasks and responsibilities, we cannot overlook the fact that promoting voluntary compliance would be the simplest, and probably the least costly, way to achieve a high level of compliance.

The promotion of voluntary compliance should be related with institutional performance, to which we have referred earlier in this presentation, service quality and the characteristics of tax regulations

Tax systems composed of clear, precise rules facilitate taxpayers' voluntary compliance. On the contrary, excessive, complex rules generate uncertainty among taxpayers, who will probably choose not to comply voluntarily with their tax obligations.

In addition, if rules are confusing, taxpayers may make involuntary mistakes when interpreting tax laws or allege misinterpretation of the law, thus increasing the level of non-compliance. This situation could imply an inefficient use of resources by the tax administration, which should therefore allocate substantial resources to prove a crime or to interpret the law.

In this sense, complexity in the wording of the law leaves room for differences in interpretation, which creates conflicts between the taxpayer and the tax administration, damaging the tax authority-taxpayer relationship.

The more complex the tax regulatory system, the higher the costs incurred by the tax administration in performing an adequate control, and by taxpayers in meeting their tax obligations. For example, if a single tax has different rates, exemptions or special treatments, the audit conducted to verify if the tax return is accurate will be more complex, which reduces the probability of detecting evasion.

On the other hand, in the case of taxpayers, the higher the cost of compliance, the greater the probability that they run the risk of not filing a return, thus not incurring the cost entailed.

Ultimately, this variable refers to the level of certainty of the tax system or, put simply, to the issue of whether tax obligations are clearly defined in the rules and if the way in which those obligations are to be met is clearly stipulated.

Facilitating compliance is an excellent strategy to promote voluntary compliance; thus, the actions aimed at improving services and simplifying processes should be approached as efforts to increase voluntary compliance.

Undertaking projects for the use of technology and new methods to improve services and thus improve voluntary compliance may result in a transformation of the culture of tax administrations. It is essential to approach these projects as contributions to the raising of compliance levels rather than as simple accessories.

Actions to facilitate compliance imply an effort in terms of improving processes, training human resources and using new technologies, which will have a favorable impact on taxpayers' perception of tax administrations' management capabilities and, hence, on the organizational and technological performance.

5. TECHNOLOGY AS A MEANS TO EXERCISE CONTROL POWERS

Technology is the most appropriate means to develop efficient compliance control systems. It provides subsystems to control compliance with the formal obligations to file returns and pay; subsystems to control collection workflows and audit case follow-up; as well as systems that make it possible to manage different data sources and generate information with a view to increasing compliance levels.

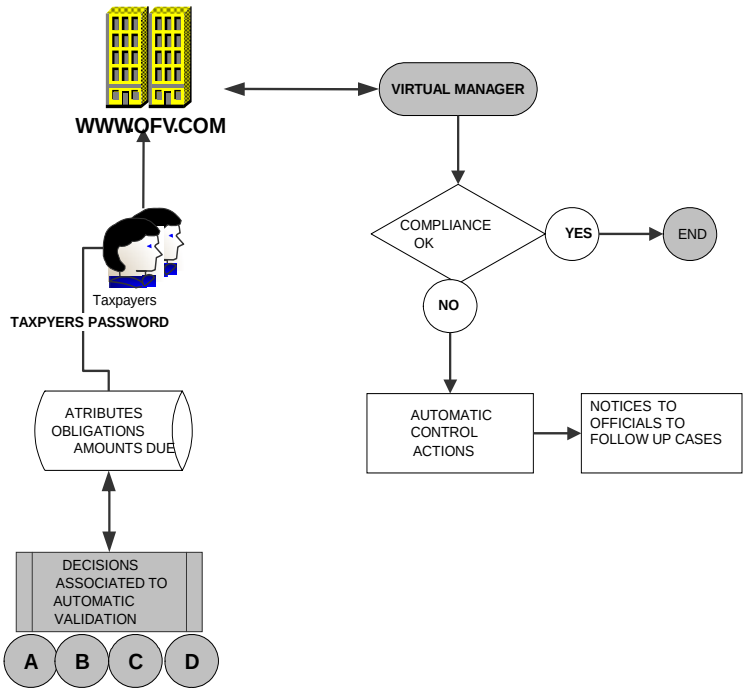
Compliance control systems have traditionally been based on the control of default and delinquency; that is, on the follow-up of the compliance with basic obligations; however, none of these two indicators measure quality of compliance, although, to mature, tax administrations need to become efficient in exercising these basic control processes.

The new technologies have had a determining impact on the way actions are implemented for compliance control at its most basic level; that is, knowing if the taxpayer that was supposed to pay did actually pay, if they paid in time and, in some cases, if they paid the amount that was actually due.

A proof of that is that years ago the goals of the projects to create a virtual office that would be the tax administration on the net –which are currently a reality- were focused on facilitating compliance and the processing of returns, while today we see them as virtual offices that allow us to design management models for virtual compliance control.

Thus, for example, when we issue electronic notices to defaulters or delinquent taxpayers, which are generated automatically upon certain events detected by the virtual office, we are limiting the discretionary powers of officials and expediting the logistics of the notification process. The following diagram shows the virtual management process associated with the virtual office.

SIMPLIFIED VIRTUAL MANAGEMENT MODEL



Approaching the relationship with the taxpayer as interactions through the virtual office without the need for a decision by any official entails forcing the tax administration to identify infringements and non-compliance events that could trigger automatic actions, which results in greater transparency.

However, turning the compliance control model into an electronic management model requires that the legislation supports the tax administration's actions. In this context, elements like the fiscal domicile and digital signature, among others, become important aspects in the compliance control process. Moving towards such a management model becomes a challenge for the transparency of tax administrations, in terms of compliance management, and for our business and tax laws.

Other processes that have been transformed as a result of the evolution of technology are, among others, taxpayer registration, authorizations to issue invoices, timely processing of payments and reconciliation of collection accounts, which until a few years ago appeared to be a heavy burden for tax administrations. In all cases, it was technology that triggered the transformation of those processes.

In many of our tax administrations, it is no longer difficult to access taxpayers' tax returns and payments on line and in real time or, in the worst of cases, during the course of the transaction that executes a call to a procedure of a "*web service*"[2], and its consequent response. The beginning of the compliance control process cycle depends on the solution to this difficulty. As soon as returns and payments are available it is possible to start verifying them.

New technologies have also transformed the way in which tax administrations exercise their auditing powers. Field audits are becoming less necessary as tax administrations improve their technology and as the powers granted by the legislation improve. Thus, for example, as it becomes possible to obtain information from third parties (other taxpayers or other institutions), and to have access to banking and customs information, the tax administration has more and better information about taxpayers. It is therefore possible to have a more accurate basis to compare the information submitted in the returns against our data without going through in-depth reviews of taxpayers' books.

[2] These applications and technologies exchange data with one another in order to offer services. Providers offer their services in the form of remote procedures and users request a service by calling to these procedures via the Web. These services provide standard communication mechanisms between different applications.

Before changing subjects, let us focus on the positive impact that the availability of information about imports has on compliance control levels. Whether the information is obtained as a result of virtual, technological or organizational integration with customs is not the relevant issue; what is important is that in highly import-dependent countries it is extremely difficult to achieve optimum compliance levels without having timely access to reliable information about imports.

However, the transformation of the auditing process I have just referred to, which has already taken place in some of our tax administrations and has just begun in others, requires an increase in the organization's capacity to adequately and timely manage, from the technological viewpoint, the data obtained, ensuring high quality and accessibility.

Desktop audits, increasingly based on crossed information, seek to increase the level of compliance, since the data contained in tax returns are of a higher quality, and, in addition, they raise the level of compliance in general as taxpayers' perception of risk increases.

The availability of more and better data to compare against those submitted by the taxpayer is a fundamental goal that tax administrations should meet in order to achieve an optimum level of compliance. Technology is the tool that makes it possible to make a more fruitful use of the options available in the legislation to request information and use it in the tax administration's auditing activities. It should be our goal in terms of auditing processes to be able to check the largest possible amount of information contained in a taxpayer's return against that available from another taxpayer or entity. The better the information we have, the better the one contained in taxpayers' returns.

In this regard, we should reflect upon the theoretical dilemma that tax administrations could face in the performance of compliance control functions. They have to strike the right balance between the promotion of voluntary compliance and the right taxpayers should have to "self-assess" their taxes and assume the risk of penalty upon any event of non-compliance, on the one hand, and the tax administration's power to assess amounts due at the same time as the taxpayer's self-assessment, avoiding the right to "free" compliance, on the other. In any case, the best alternative will always be the one ensuring a higher compliance level –whether voluntary or induced by the tax administration- for the benefit of society, which needs the revenues we raise.

The tax legislation can provide significant freedom for the tax administration to request or obtain information directly, but the inadequate management of those options, from the technological viewpoint, can lead to a process of “indigestion” in the organization, preventing the good use of the information and reducing taxpayers’ perception of the effectiveness of the tax administration.

Designing adequate data bases and timely and reliable data integration processes has become a key activity for tax administrations to implement effective compliance control processes. At this point, it is of critical importance that tax administrations have technicians specialized in the field of technological infrastructure, who can design and implement information systems, manage data bases and develop a reliable and highly-available data network.

The use of workflow management technologies changes the way officials work because it helps them assess and detect events of inappropriate conduct, since it makes it possible to create systems to control work processes, like auditing and collection; to record and control measures taken to collect amounts due; to plan the field work for audits; and to measure execution times of each one of these tasks.

The availability of multidimensional data bases which are relatively easy to implement and which can perform analytical processes (business intelligence) allows the tax administration to innovate in two key aspects of control and/or audit process improvement. First of all, in the selection of audit cases, as econometric and analytical models are developed, which take into account the most diverse and simple data, and, secondly, in the projection of collection and its subsequent analysis. Designing collection and audit “buckets” to obtain support data to select cases by industry sector or by type of taxpayer and analyzing revenue results against estimates is now part of the business of any tax administration that wishes to improve its compliance control processes.

Taxpayers’ perception of risk depends, to a large extent, on the adequate selection of taxpayers to be subjected to a thorough or field audit.

Implementing actions that hamper the operation of delinquent taxpayers in the rest of the government agencies could have a positive effect on compliance levels. When it comes to risk perception as a tool to favor compliance, it is essential to have a good collection system and to define collection models with which the rest of the government sector should cooperate in some way. This comprehensive view of government helps improve basic compliance control processes.

On the other hand, many of our countries do not have a comprehensive plan in the government sector to implement measures to keep an updated Register of Taxpayers, or to systematically detect defaulters or substantial events of non-compliance. The widespread and mandatory use of the Single Taxpayer Register for any business activity continues to be the core of any compliance control scheme.

Even if we talk about technological development, we cannot fail to admit that achieving operational efficiency in the use of taxpayer lifecycle management systems continues to be a challenge for our tax administrations. The optimum registration of taxpayers, the updating of taxpayer data and obligations, and the control of compliance with taxpayer formal obligations have not ceased to be a headache for our tax administrations. Sometimes we do not make full use of the all-round view of taxpayers that this single registration offers together with the advantages of integrated systems as a result of the inadequacies of our organizational structures.

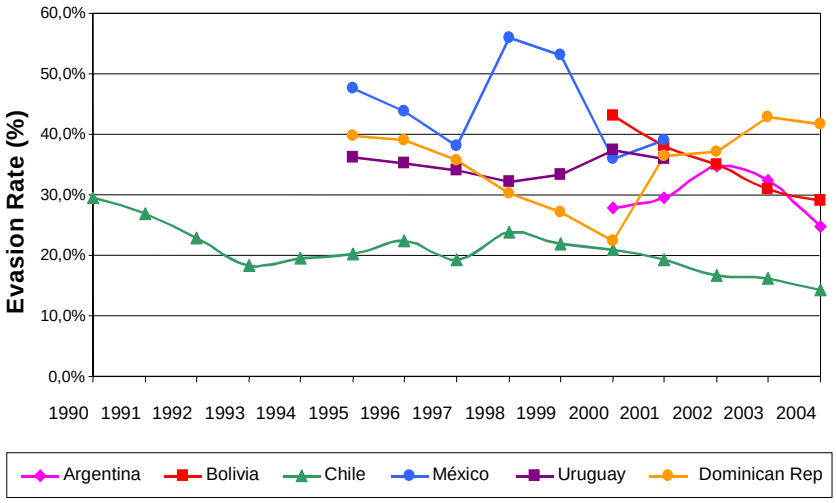
Likewise, it is necessary to weigh the most basic contribution of technology in the search for the right balance between compliance control on the part of the tax administration and ease of compliance for taxpayers. In this regard, technology has also become an essential tool to give some freedom to tax administrations in defining assessment and payment methods. To maximize the use of technology it is necessary for the legislation to allow the storage of electronic documents and include other elements to foster the use of electronic transactions.

Definitely, profiting from the positive aspects of institutional and technological performance in a coordinated and strategic manner has a very positive impact on compliance levels.

6. PRACTICAL CASE OF CONTROL MEASURES IN COUNTRIES WITH A LOW COMPLIANCE LEVEL

One case that we would like to present in order to analyze the effects that institutional credibility, technology, and the integrated use of the powers granted in the regulation can have on compliance levels is General Rule 8 issued by the DGII of the Dominican Republic in 2004. The idea is to show how it is possible to profit from a late implementation of the most advanced techniques of compliance control processes, by learning from the difficulties faced by others.

Evasion in Latin America [3]



Sources: AFIP, for Argentina; SIN, for Bolivia; SII, for Chile; SHCP, for Mexico; DGI for Dominican Rep.; and Cobas et al., for Uruguay. Note: In the case of Argentina, the "VAT non-compliance coefficient" has been considered, which is a concept broader than that of evasion.

The above-mentioned Rule stipulates that, when paying to affiliated merchants the amounts consumed (debit and credit card sales), credit and debit card companies[4] should withhold a percentage of the amount indicated in the invoice or of the Tax on Transfers of Industrialized Goods and Services (ITBIS[5]) indicated in the voucher. It is an ITBIS or VAT withholding. What I would like to stress here is that this being the first time a regulation like this was issued in the Dominican Republic, there was great opposition to it.

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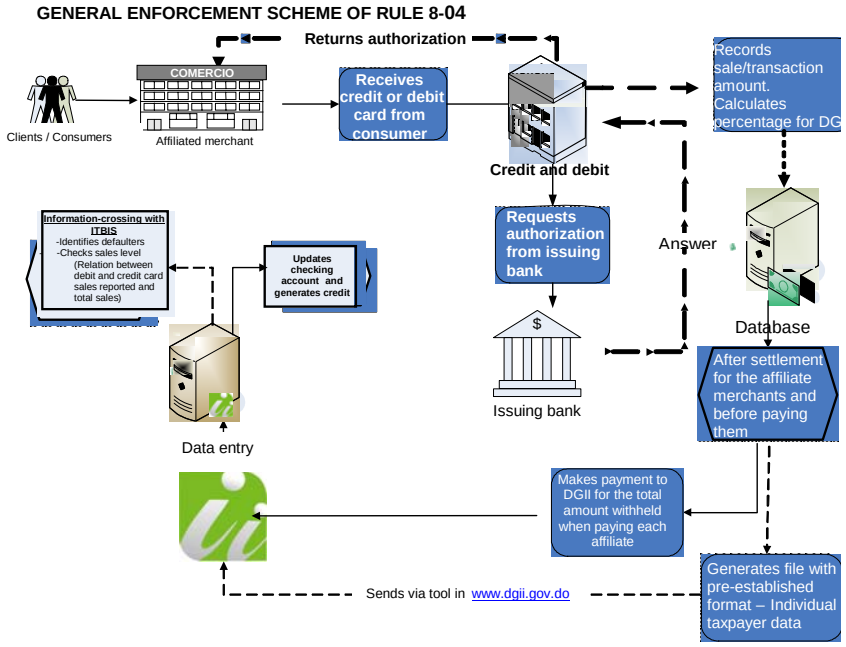
[3] Taken from M. Victoria Espada Tejedor's presentation *Evasion and Tax Spending in Latin America*
Division of Budget Policy and Public Management, ILPES, CEPAL, United Nations, in the 1st INTERNATIONAL COURSE ON MACROECONOMIC POLICY AND PUBLIC FINANCE
Santiago de Chile, November 7 – 18, 2005

[4] These are companies that manage the processing of debit and credit card transactions, acting as intermediaries between the card issuing bank and the affiliated merchant. They manage the technological platform and payments for credit and debit card sales.

[5] ITBIS is the Tax on Transfers of Industrialized Goods and Services, the name given to VAT in the Dominican Republic. The tax rate is 16% with exemptions for half the GDP.



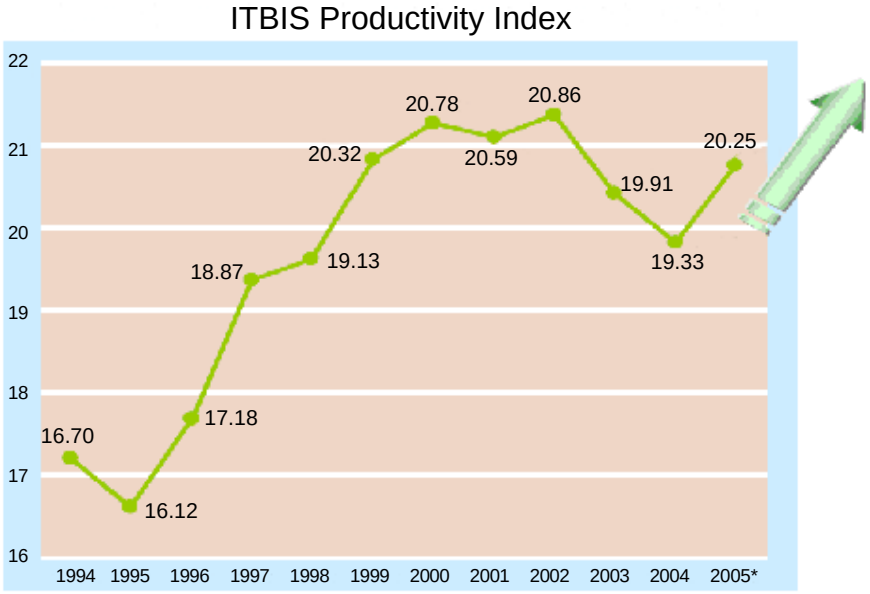
It was not an easy task to convince the sectors “affected” and society as a whole that this type of measures contributes to improving compliance control processes and reducing evasion, thus favoring equity.

In this context, it was necessary to include and coordinate tasks with the sectors involved: first, the merchant companies (big stores, restaurants, supermarkets, hardware stores, etc.) that account for the largest debit and credit card sales volume, and secondly, debit and credit card companies themselves, which had to invest resources to adjust their systems so that the “voucher” would include the ITBIS and for the electronic reporting of data.

In both cases, the implementation of the process was made possible by the credibility of the tax administration and the trust in its capacity to succeed.

From the technology viewpoint, it was necessary to implement an information submission tool that would make it possible for each taxpayer, when making the payment, to benefit from the credit registered in his checking account in the amount of the payments made on his

behalf by the debit and credit card companies. Thanks to the success of this tool, taxpayers were not affected and were able to use their credits in due time. In addition, the detection of partially or totally defaulting taxpayers and of underreported sales as compared to the sales reported as effectively made with debit and credit cards led to greater collection and tax productivity.



* Estimated

Before implementing this measure, the ITBIS was measured in order to weigh impact. Figure 1 shows that there has been a reversal in the last years' downward trend in ITBIS productivity, which has now resumed an upward trend.

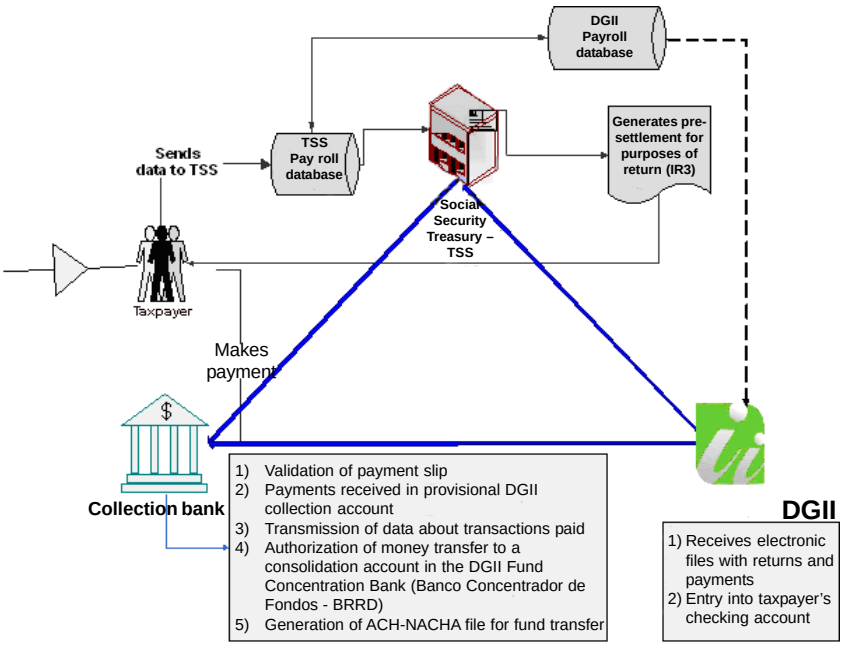
Another case that is important to present is the creation of a strategic alliance with another government agency to obtain results in terms of raising compliance levels.

General Rule 10 of 2004 unifies the process of declaration of Wage Earners Income Tax withholding with the Social Security declaration under the responsibility of a government agency called Social Security Treasury (TSS). This process is an example of technological integration and cooperation to achieve an objective –improving the level of compliance in two taxes that share taxpayers and have almost the same base.

Thus, all employers make their electronic submissions through a Web application developed by the TSS for this special purpose, and, with this information the DGII and the TSS run their processes to calculate the amounts to be withheld on an individual basis, by employee, and consolidated by employer. The employer receives a payment authorization and makes the payment in any authorized bank.

In this process, both the TSS and the DGII have the information about each employee and their salary and they can run verifications of the individual and the withholder.

In the case of the DGII, these data feed a Crossed Information System that makes it possible to verify, among other things, the compliance of employees that have, for example, more than one salary, and that of the employer, with the purpose of selecting cases for auditing by comparing the payroll report with its economic sector.



The positive results of this administrative measure can be seen in the increase in the collection obtained and in the number of taxpayers. Collection exceeded those of the previous year (2005 versus 2004) by 12% in spite of an increase in tax exemption which was expected to cause a 10% reduction in revenues. In addition, this measure resulted in a 31% increase in the number of wage-earners subject to withholding.

The administrative measures described above affect a large number of taxpayers and therefore increase the perception of risk of the entire universe of taxpayers. Hence their positive results, which are consistent with the behavior expected from a society with a low compliance level, that is, leaps towards improving voluntary compliance.

However, the consistency of the levels of compliance achieved will be subject to a high institutional and technological performance.

Case study

TOPIC 2.3

THE IMPORTANCE OF LEGISLATIVE CHANGES TO REDUCE TAX EVASION AND AVOIDANCE

Sabina Walcott-Denny
Commissioner of Inland Revenue
Ministry of Finance
(Barbados)

CONTENTS: Introduction.- Steps to Legislative Changes.- Corporation and Individual Tax System.- Introduction to the New Tax Regime – From Consumption Tax to VAT.– Specific Transactions.- The use of Administrative Tools.- Conclusion.

INTRODUCTION

The main function of a tax administration is the efficient collection of taxes. Efficiency in this environment dictates maximization of tax collection via the utilization of modern collection methods, combined with an enforcement arm that is swift, meaningful and results-oriented. Unfortunately, this goal is in direct conflict with that of the taxpayer whose goal is to minimize his tax liability, usually by legal means or at times by illegal means. Legislative changes are then used by the tax administration to fulfill its mandate and to reduce tax evasion and avoidance.

Definition

The Wikipedia encyclopedia described tax avoidance as “the legal utilization of the tax regime to one’s own advantage, in order to reduce the amount of tax that is payable by means that are within the law”. In contrast, tax evasion is “the general term for efforts by individuals, firms, trusts and other entities to evade the payment of tax by illegal means”.

Policy, Administration and Legal Processes

Legislative changes cannot be examined without establishing the reason for the changes and whether or not any part of the tax systems has contributed, either directly or indirectly, to the need for the changes. Without a doubt, the policy, administration and the legal processes within the system impact heavily on the taxpayer and may encourage them to pursue less than honest means in reporting their income. For example, if the tax rates are high, persons are more likely to seek means of evasion and avoidance.

STEPS TO LEGISLATIVE CHANGES

The usual process:

- Existing Situation
- Policy Direction
- Legislation
- Administration
- Experience of Tax Evasion and Avoidance
- Legislative Changes

The Importance of Legislative Changes

Legislative changes are important and necessary when tackling tax avoidance and evasion. The changes are used to:

- implement new overall policy direction
- discourage sophisticated tax planning
- correct oversights made when original legislation was drafted
- correct ambiguity
- reduce potential fraudulent and illegal activities

THE BARBADOS EXPERIENCE - Areas and activities where legislative changes were used as a measure to reduce tax evasion and avoidance

- Corporation and Individual Tax Systems
- Introduction of a new tax regime – from consumption tax to Value Added Tax (VAT)
- Specific transactions
- Administrative tools

General

In Barbados, there is a constant review of the tax system. Recommendations are made by the tax administration and other organizations to influence policy directions of the government.

CORPORATION AND INDIVIDUAL TAX SYSTEM

1990's - Reform

During the 1990's, significant reform of the individual income tax system was undertaken. One major objective was to reduce possible tax evasion and avoidance through the reduction of several deductions and allowances.

These included:

- unlimited mortgage interest on owner occupied residence
- unlimited repairs/improvements on owner occupied residence
- insurance premium on owner occupied residence
- dependent relative allowance
- child maintenance allowance
- spouse maintenance allowance

The main aim of the reform was to make the system less complicated. In addition, the tax bands changed from five bands to two bands. It was noted during this reform that the simplicity of the tax system and tax return forms lead to less evasion and more compliance.

2002 - Reform

In 2002 resulting from the expected regional union 'The Caricom Single Market and Economy" (CSME) and world trade issues, a detailed examination of the position of Barbados relative to its neighbors and other jurisdictions, was made. It was noted that there was a trend to low tax rates both at the individual and corporate level. The Chart below shows the tax rates of the competitors.

Barbados Competitors Tax Rates- 2002

	Corporate	Individual	
Jamaica	33.33	25	(Single rate)
St. Lucia	33.33	30	(Marginal rate)
Trinidad	35	35	(Marginal rate)
Guyana	33.33	33	(Marginal rate)
Barbados	40	40	(Marginal rate)

It was noted that tax evasion and avoidance with respect to companies would present some challenges. Recognition was given to the possibility of revenue shifting. Consequently it was decided to lower the tax rates gradually. It was recognized that there would be revenue loss in the short term but in the long term there would be an increase in revenue and more economic growth.

New Tax Rates

Sections 42 and 43 of the Income Tax Act were amended to reflect the current trend of lower rates. The chart below outlines the rates for corporate and individual income tax.

Year	Corporate Rate	Individual Rates	
2002	37.5%	25%	(40% - marginal rate)
2003	36%	22.5%	(40% - " ")
2004	33%	20%	(40% - " ")
2005	30%	20%	(37.5% - " ")
2006	25%	20%	(35% - " ")

INTRODUCTION TO THE NEW TAX REGIME – FROM CONSUMPTION TAX TO VAT

Prior to 1997 the tax system of Barbados consisted of tax on income - corporate and individual - and numerous types of consumption taxes. Accompanying these different consumption taxes were various rules and varied rates. The result was an ineffective administration and loss of revenue through tax evasion and some measure of tax avoidance as the many of the legislations contained several loopholes.

The following are some of the consumption taxes which existed prior to 1997:

- Travel Ticket
- Small Crafts
- Entertainment
- Hotel and Restaurant
- Airline Service
- Tax on Quarriable Minerals

After an analysis of the many difficulties encountered in the collection of these taxes, suggestions were made to improve the overall system and decrease the potential revenue loss.

In 1997 the Valued Added Tax legislation was introduced and the numerous consumption tax acts were repealed. The change in legislation was important. It brought all the different consumption taxes under a single regime. Tax rates were 0, 7.5% or 15%. This system has proven to be successful in reducing the level of tax evasion and avoidance. In fact, revenue collection under this new system has increased significantly.

SPECIFIC TRANSACTIONS

Certain transactions are used by taxpayers for tax evasion and avoidance. Legislative changes are used to "plug any loopholes". The chart below summarizes some areas where legislative changes were made and the specific abuses that were prevented.

Legislation	-	Specific Abuse Prevented
Group Relief	-	underreporting of income
Loans to Directors without	-	utilization of company funds without repayment
Artificial Transactions	-	under/over valuation of asset
Final tax on dividend and interest	-	non-reporting of dividend and interest

Group Relief - Section 23A –Income Tax Act

Legislative changes in the area of group losses act as an effective tool to discourage tax evasion and avoidance. In Barbados, a company that is part of a group is allowed to set off a current trading loss against the taxable profits of another company in the group, provided that certain criteria are met. The relief was designed to encourage profitable companies to invest in other activities that might not be immediately profitable.

In Barbados, companies are allowed to carry forward tax losses for nine years. To ensure that companies do not abuse the use of the group relief provisions, a company is not allowed to make a claim for group relief unless the profits of the claimant are first applied against any previous years' losses of that company.

Loans to Directors - Section 27A – Income Tax Act

Some company directors, especially those in controlled companies, may use their position to seek advances and loans from these companies. To counter this eventuality, legislative changes were used. The legislation does not prohibit a company from making advances or loans to a director but it simply ensures that directors do not abuse this privilege. Any loan or advance made by a company to a director must be repaid within one year or it is deemed income to the director in the year the loan or advance was received. Without this stipulation a director may use company's funds without incurring any interest expense and with no stated period of repayment.

Artificial Transactions -Section 29 – Income Tax Act

Tax evasion and avoidance schemes are practiced by taxpayers at all income levels. There are situations where the true cost of an item is not reflective of its true market value. To ensure that a market value is not understated because of the relationship between the buyer and the seller, legislation is used by the tax administration to disregard or modify a transaction if it is not an arm's length transaction.

Final Tax on Dividends and Interest –Section 48B and 48C - Income Tax Act

It was recognized that persons were making loans to companies and were being paid handsome amounts of interest but not paying any taxes. The change in legislation made it mandatory for the company paying the interest to deduct 12.5% as a final tax and submit the same to the Commissioner by the 15th of the month following the month in which the interest was paid. The same treatment was applied to the payment of dividends.

THE USE OF ADMINISTRATIVE TOOLS

Barbados uses a number of administrative tools to reduce tax evasion and avoidance namely withholding tax, access to taxpayers' bank records, the authority to garnish taxpayers and raise assessments when necessary.

Withholding Tax

Payments to non-residents are subject to withholding tax as follows:

Gross earning of entertainers	25%
Interest	15%
Royalties	15%
Dividends from tax profits	15%
Branch profits	10%
Technical/managerial services	15%
Other services	25%

It is noted that this systems has been very successful in capturing taxes that otherwise would not be collected.

Access to Bank Accounts – Section 76 – Income Tax Act

Section 76 (1) states inter alia:-

(1) "a person authorized by the commissioner for any purpose related to the administration or enforcement of this Act may, at any reasonable time, on production of his letter of authorization enter into any premises or place of business is carried on or any property is kept or anything is done in connection with any business or any books or records are or …….*audit or examine the books and records* …..

(7) "without restricting the generality this section, *applies to banks.*"

The authority to access bank records of taxpayers provides a formidable tool in assisting the tax department to trace unreported income and money earned from illegal activities by a taxpayer.

Garnishment

Section 73 (1) states – "where the Commissioner believes that any person is indebted to or liable to make a payment to another person and that other person is indebted to the Crown under this Act, the Commissioner may deliver to the firstmentioned person a demand for payment stating the name of the person indebted to the Crown and the amount of debt……"

This provision gives the Commissioner the authority to collect taxes due from a third party who has funds on behalf of a taxpayer."

Technological Solutions

CIAT Project-2006

Barbados has recognized that an efficient and effective tax administration requires the use of the latest available technology. The CIAT Project which is scheduled to start shortly will provide Barbados with the opportunity to make use of the latest technology to improve its services to taxpayers and to introduce e-filing.

Legislative changes to facilitate automated systems that would allow electronic transmission of information, e-filing, sending and receiving of returns, and other statutory obligations of the taxpayer are expected.

CONCLUSION

The tax system in Barbados is frequently reviewed for any potential leakage. It is recognized that a tax system which has a measure of simplicity, a high degree of equity and operates in a stable environment is less likely to have high levels of evasion and avoidance. However, there will always be persons who unjustly seek to minimize their tax liability. Legislative changes will always be a useful weapon to reduce such challenges and maximize potential collection of revenue.

Case study

TOPIC 2.3

THE IMPORTANCE OF CHANGES IN LEGISLATION TO REDUCE TAX EVASION AND AVOIDANCE

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CONTENTS: 1. Introduction.- 2. Background.- 3. Examples of changes in legislation.- A. Changes aimed at closing loopholes in the law.- B. Changes aimed at improving control and monitoring of taxpayers.- C. Information exchange and cooperation measures.- D. Other general legislative measures with an impact on tax evasion.- 4. Final Remarks.

1. INTRODUCTION

In addressing the subject "The Importance of Changes in Legislation to Reduce Tax Evasion and Avoidance" in the context of the main theme of CIAT's 40th General Assembly, "Potential Tax Collection as the Goal of Tax Administrations", we seek to present the recent experience in Brazil. The SRF –Secretariat of the Receita Federal (tax collection agency)- participates in the design of the tax policy of the Federal Government and it has thus accompanied changes in tax legislation. The Receita Federal is very often called upon to issue an opinion about the scope of legislative projects,

both in terms of merit and estimation of potential impact on collection. On other occasions, it is the SRF itself that drafts the proposed piece of legislation for consideration by the Ministry of Finance and the National Congress, in particular when, during its usual activities, it finds loopholes in the law or room for changes that could improve its control over taxpayers' transactions. There are also regulations issued by the tax authority itself which, although passed only to regulate existing laws, may have significant effects on the risks for those that practice tax evasion and reduce opportunities for underpayment and tax deferral.

Thus, it is our understanding that a tax administration can have an active and important role in helping draft tax laws, particularly by contributing its experience to the debates on measures, which will most probably include other parties as well. This paper will present examples of legislative measures taken in Brazil in the last decade, aimed at reducing tax evasion and avoidance. The presentation is divided into three parts, in addition to this introduction. The following section briefly describes the macroeconomic context in Brazil so that the reader can better understand the situation that led to the legislative anti-evasion and anti-avoidance measures discussed in the third part. No reference is made to legal acts so that the text is not too cumbersome. Examples are divided into four types of legislation depending on objectives in terms of fighting tax evasion and avoidance: measures aimed at closing loopholes in the law, measures aimed at greater control on the part of the tax administration, measures for cooperation to exchange information or perform joint action, and other, more generic measures (that is, measures that even if taken for purposes other than combating tax evasion and avoidance, turned out to be effective in this regard as well). The conclusion is presented in section 4.

2. BACKGROUND

Since the macroeconomic adjustment plan in 1994 (Plan Real), which arrested a hyperinflationary process of two decades in Brazil, the maintenance of fiscal balance has been a fundamental element for the country's economic stability. In other words, Brazil decided not continue funding its spending by printing money and taking up debt, and has sought to balance its accounts and even reduce its debt/GDP ratio by means of fiscal surplus. In this sense, tax collection plays a fundamental role given the fixed level of expenditures in Brazil.

In order to achieve the goal of having primary fiscal surplus, several changes to the legislation were made in the past (resulting mainly from the external crisis in 1999). Many of those changes entailed an increase in nominal tax rates, expansion of the tax base and even the inclusion of bases that were not subject to taxation before. It was a typical collection effort and both the government and Brazilian society now recognize that the tax burden is heavy.

Thus, it is the current administration's policy to work in order to arrest the upward trend of the last decade. Consequently, tax exemption measures have been adopted, even with nominal tax cuts, precisely because the SRF has become more efficient in combating evasion. The fight against tax evasion and avoidance (through control or legislative actions) has generated revenues which, in turn, enabled the adoption of tax reduction policies, thus keeping the tax burden stable. In this sense, it is important to mention that an effective way to fight evasion, in particular the unintentional forms thereof, is to simplify and improve the quality of the tax system. Thus, Brazil has sought to adopt income presumption regimes for micro and small companies, the substitution of value added taxation (which has the advantage of being less distorting for the economic system and allowing for self-control in the production chain) for cascading systems, capital goods tax exemption, among other measures.

In summary, this is a unique point in our history, since anti-evasion and anti-avoidance measures that were used in the past to complement other legislative measures to increase collection, are now being adopted as an essential element to even reduce taxes in the formal sectors of the country's economy. Another objective is to make the Brazilian tax system more equitable so that each economic sector can pay its corresponding taxes. All this means that there is a clear perception that this is the right time to improve the efficiency and equity of the system, which could not be done during the crisis, when all the attention was focused on how society would respond to the need to make greater fiscal efforts.

Therefore, the role of the Receita Federal became essential for the execution of government policies, and the tax administration has made an effort to collect more efficiently and has come down harder on tax avoidance and fiscal fraud. In fact, the crimes of money laundering, smuggling, piracy and corruption are increasingly part of the tax authority's arid field of action. In this scenario, the Receita Federal has been involved in the drafting of rules, even producing complementary rules, in a continuous effort to ensure enforceability of the tax legislation. At the same time, it has strengthened its examination and control activities, as shown by the larger work force

employed in these activities, the creation of a specific fiscal intelligence unit, the creation of a unit specializing in punishing smuggling and illegal exports, in addition to increasing investment in training and state-of-the-art technology.

3. EXAMPLES OF CHANGES IN LEGISLATION

It is clear that tax evasion and avoidance must be attacked by means of multiple methods, based on a clear strategy devised by the tax administration. As mentioned in the Technical Program of this Assembly, strategies can be adopted in the areas of administration, examination and legislation. Each tax administration should decide what strategies and actions should be chosen as priorities to achieve the goal of reducing tax evasion. The measures recently taken by Brazil include changes in all the above-mentioned areas, but this paper will discuss, specifically, the changes made in legislation.

To facilitate understanding, the changes to the legislation mentioned here are classified into four groups. The first one refers to changes aimed at closing loopholes in the law that enable tax planning and avoidance. The second one comprises legal instruments or rules that establish mechanisms allowing the tax administration to perform a better follow-up and monitoring of taxpayers with a view to reducing illegal activities and evasion. The third group is composed of measures relative to exchange of information and agreements with other tax administrations or related entities. Finally, we will discuss broader measures which also have a significant impact on the reduction of tax evasion and avoidance.

A. Changes Aimed at Closing Loopholes in the Law.

Among some of the measures aimed at closing or reducing loopholes in the law, it is necessary to highlight the changes made with a view to reducing the possibilities for tax evasion and avoidance resulting from globalization. This was important for Brazil because in the early 90's the Brazilian economy opened up to international trade. It was then necessary to adopt measures to curb the practice of tax evasion and avoidance through international transactions, which became increasingly common in Brazil. More specifically, Brazil adopted legislation referring to worldwide taxation, transfer pricing control and control of transactions with tax havens.

Worldwide taxation regime

Until 1995, Brazil had a territorial regime of taxation under which income subject to tax was only that earned in the country, the income that Brazilian companies earned abroad not being included for income tax purposes. The measure adopted, in addition to bringing the Brazilian legislation into line with international practice, closed a big gap that used to enable companies to transfer income overseas with the clear intention of avoiding payment of the corresponding tax in Brazil. Brazilian authorities thus confirmed their decision to forcefully combat capital flight and to firmly pursue the realization of the taxation potential. This measure had real effects for those companies that operated in countries with low or no taxation or with income taxes at levels lower than those in Brazil. In this case, the law tried to ensure that those companies would pay a tax of the same level as the one paid by companies operating exclusively in the national territory.

Transfer pricing legislation

Although the legal measures mentioned above did bear some connection with transfer pricing in Brazil, the legal framework establishing the rules for the application of such prices dates back to 1996. The new law allowed Brazil to enter the competitive world market and prepare for the growth of Mercosur, since it established clear tax rules and adopted the widely accepted arms' length principle and terminology similar to that used in other countries, applicable to transactions among related companies.

It would not be fitting to discuss here the details of Brazilian legislation; however, some interesting changes are listed below by way of an example for the purposes of this study:

- the burden of proof now lies with the taxpayer, who has to prove that the prices used are the same as those of the open market;
- the legislation establishes seven valuation methods, some of which are similar to those used in other countries, but differentiating imports from exports to take into account the economic and legal situation of Brazil;
- the law also established minimum and maximum levels for interests charged and paid among related companies.

It is worth mentioning that the Brazilian legislation was the result of an intense debate with the private sector, which made several suggestions. The law does not set forth prices to be charged or results to be obtained.

Its main objective is to prevent manipulation of results and ensure that income earned in the country is subject to tax in the country and not transferred to other nations.

Legislation on tax havens[1]

As the process of international tax competition evolved, and with the proliferation of areas with low or no tax rates, also known as tax havens, the governments that are adversely affected by this unfair competition have sought alternatives to minimize the impact of this process on their finances. It appears to be clear that an ideal solution to counteract this problem should be based on multilateral measures or sanctions against tax havens. However, given the slow process of discussion of this issue, in 1995, Brazil decided to unilaterally adopt legislation establishing measures to protect the National Treasury from harmful transactions with tax havens. At that moment, the issue started to be addressed in Brazilian legislation and tax havens were objectively defined as those countries that do not tax income or whose maximum income tax rate is lower than 20%. In addition, the legislation also treats as tax havens those countries whose internal legislation provides for secrecy relative to the ownership structure of legal entities.

This objective definition was a necessary condition for the adoption of specific rules aimed at curbing tax avoidance by shifting tax bases. In fact, the latest legislation contains instruments for a differentiated treatment for companies making transactions with other companies located in countries with low or no tax rates. Some examples may be given in this regard.

Firstly, the law stipulates that transactions between individuals or legal persons residing or domiciled in Brazil and any individual or legal person residing or domiciled in a low or no taxation area (tax haven) are subject to the rules relative to transfer pricing, which were mentioned above.

Secondly, proceeds paid to an individual (or legal person) residing or domiciled in a tax haven are subject to an income tax withholding at the source of 25%, while in the case of individuals or legal persons domiciled in countries with regular taxation, the normal rate is 15%.

Thirdly, a recently adopted measure exempted from interest the investments of non-residents coming to Brazil to buy National Treasury bills. The

[1] Text based on the book “Tributação da Renda no Brasil Pós-Real” (Tax on Income Earned in Post-Real Brazil), by the SRF.

regulation expressly stated that investments coming from tax havens would not benefit from such exemption. Thus, these investments will pay the 15% income tax withholding at the source. A similar measure is also applied on investments made by foreigners in the Brazilian stock exchange.

Hence, the current legislation not only defines the concept of tax haven but it also sets forth clear criteria to differentiate transactions with low or no taxation areas from those that are considered normal transactions, thus preventing the National Treasury from losing revenues from those transactions.

Other changes – Globalization

Even after the adoption of this set of measures, Brazil is seeking to continuously improve legislation to prevent tax planning. Therefore, in addition to those already mentioned, several other changes were introduced to put a stop to opportunities for evasion and avoidance arising from the process of globalization. Many of them are related with transactions in the financial market. For example, an article in the law that enabled a privileged treatment for risk hedge transactions in the futures market abroad has been repealed. It was found that the said mechanism was allowing the remittance of earnings abroad, the beneficiaries of which were related or controlled companies, with a zero income tax rate on the funds remitted and also with deduction of losses on results corresponding to the legal person domiciled in Brazil.

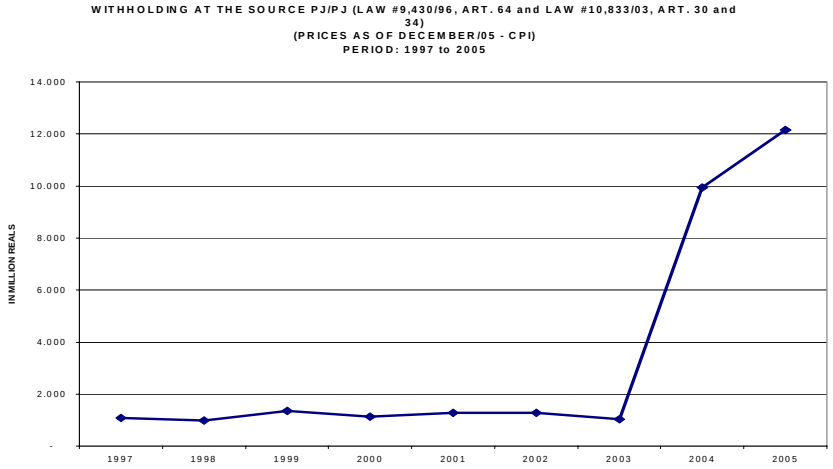
B. Changes Aimed at Improving Control and Monitoring of Taxpayers.

Withholding at the source

Withholding at the source is recognized as one of the most effective mechanisms to combat evasion. It generally achieves an increase in revenue, although in a zero evasion environment, the withholding would be just an advance of the tax that would be subsequently paid in full. In Brazil, there are several situations in which withholding at the source is applied for different types of taxes. In all cases, the experience has consistently led to an increase in the revenue flow immediately after the introduction of the mechanism, which proves the existence of evasion practices and the effectiveness of withholding at the source to fight against it. The following are some recent experiences in Brazil.

First, the introduction of an obligation, as from 01/01/97, for government bodies to withhold and pay to the Treasury taxes derived from the provision of goods or services to the said bodies. This was an important measure not only from a strictly tax viewpoint but also for administrative morality reasons. In fact, tax evaders had the audacity to not pay taxes due as a result of payments made to them by government bodies. Since the measure proved to be successful, it was extended to private companies in 2004, since they can be controlled more easily than the universe of their suppliers. Both measures accounted for an increase in tax revenues. The following chart shows the behavior of revenues from taxes withheld at the source as a result of the measures adopted. There is a sharp increase in collection in 2004, when the obligation to withhold was extended to the rest of the companies.

Chart 1



A second case was the obligation to apply income tax withholding at the source to decisions of the Labor Courts. It was found that in labor lawsuits, very often, when the court decided in favor of the taxpayer, the taxpayer would receive the money and not pay the corresponding tax. It is interesting to mention that if their salaries were being paid directly by their employers, they would normally be subject to income tax withholding at the source. The new rule eradicated the problem.

A third case involved private provident plans. The market offered plans as if they were exempt from income tax if surrenders were up to an amount that the Brazilian law defines as “limit of exemption”. In fact, that limit is applicable to the total returns obtained in the month by the individual taxpayer. The use of surrenders in violation of the rule was an event of tax evasion, but the

administrative cost of control could be very high on account of the large number of taxpayers and surrender transactions. The introduction of taxation at the source on any amount surrendered allows controls to focus on provident fund managers only.

Another case was the withholding of income tax at the source in the settlement of stock exchange transactions at a rate of 0.005%. In addition to identifying the taxpayers that make transactions in the capital markets, withholding at the source helps estimate the volumes being transacted. This has helped examine transactions that used to go unnoticed by the tax authority before. The tax withheld may be deducted from the net income tax assessed for the month or compensated against the tax on subsequent income, so as not to increase the tax burden on the taxpayer.

Adoption of single-stage regimes

Another successful experience in Brazil has been the implementation of single-stage regimes for consumption taxes in the sectors of the economy mostly affected by evasion. We found that certain production chains, in particular those with a retail sector that is highly fragmented into many small companies, tend to pose greater problems in terms of evasion. Examples are the sectors of fuels, automobiles and auto parts, pharmaceutical products, cigarettes and beverages, among others.

For these sectors, a single-stage taxation system was implemented, that is, a system under which taxes are levied only once along the chain, replacing all the taxation events that would occur on the value added in each stage of production. Thus, control and collection focus on large companies, of which there is a smaller number, while small companies do not have to pay any additional tax. Control becomes easier and collection occurs in the first stages of the production cycle, leaving no room for tax avoidance in the retail sector.

The charts shown below illustrate the results obtained with these measures. The first chart shows the impact that single-stage taxation has had on the automotive sector, and the second one, on taxation of fuels. The taxes considered are taxes levied on the value added, but which, due to the characteristics of the sector, are being collected in a single stage.[2] In both cases, the measures taken caused an increase in revenues proportionally greater than the decrease in collection from activities that ceased to be taxed. In Chart 2, the blue line represents the revenue raised from assembly

[2] The taxes considered are PIS (Social Integration Program) and Cofins (Social Contribution on Turnover), mandatory contributions of a social nature payable by companies, which may be levied on turnover or on value added.

plants, which increased upon adoption of the measure in 2000, while the red line represents the revenue raised from retailers, which decreased, but not in the same proportion as the increase in revenues derived from assembly plants. A similar rationale can be applied to Chart 3, with the difference that in this case we are looking at the behavior of revenues raised from refineries and fuel distribution companies.

Chart 2

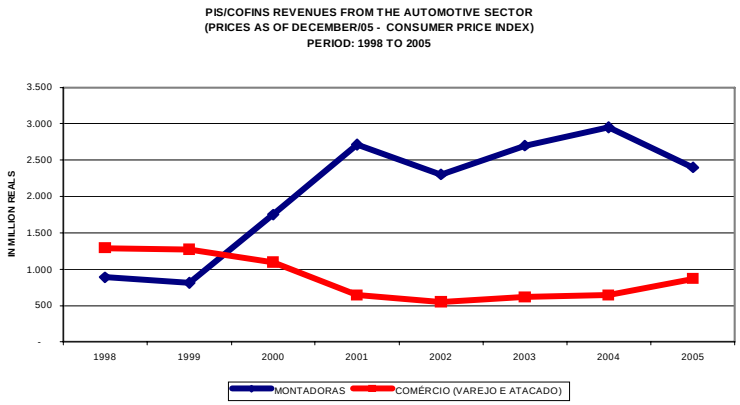
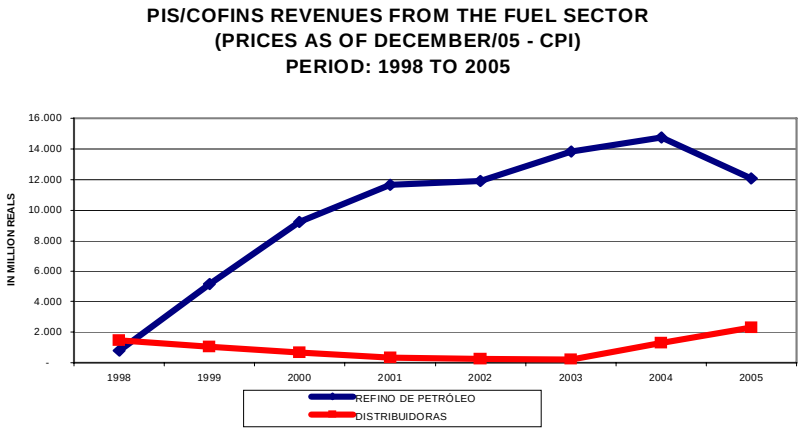


Chart 3



Adoption of specific taxation (ad rem) for specific products

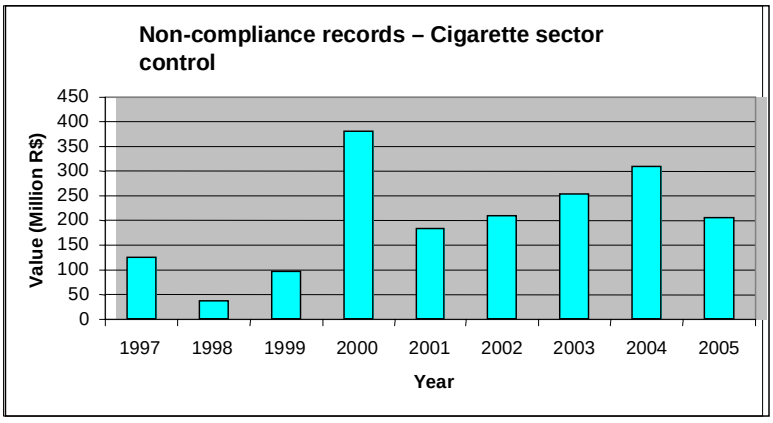
To complement the single-stage regime, for products that are difficult to control, subject to high taxation and liable to be subject to avoidance, Brazil adopted a specific rate (ad rem) on the basis of quantity. This applies in particular to cigarettes, beverages and fuels, and it helps keep a stricter control on production.

Let us now take cigarettes as an example. It was difficult and slow to prove tax breaches when the tax rate was ad valorem, since there was a large variety of trademarks and prices. After June 1, 1999, cigarettes started to be taxed under a specific *ad rem* rate according to the classification of the product.

This change in the taxation system brought about an increased control of the sector by the tax administration because different control stamp models were established for the different classifications mentioned before. The stamps, which are provided by the Secretariat of the Receita Federal, must be affixed by manufacturers to packages containing twenty cigarettes; therefore, it is possible to know exactly how much the tax administration will collect. In addition to this, since 2000, it is mandatory to provide information about cigarette production and control stamp usage through the Special Declaration of Fiscal Information (DIF - Declaração Especial de Informações Fiscais-Cigarrillos) that cigarette manufacturers have to submit over the Internet to the Secretariat of the Receita Federal on a monthly basis.

Chart 4 below accurately shows the changes made by the Secretariat of the Receita Federal and the results obtained from the examination of cigarette manufacturers in the last few years. Note that as from 1999 there was a significant increase in the amounts of non-compliance records, which points to an improved control of the production of the sector and the revenues obtained from it. This allows the tax administration to act more expeditiously when there are indications of non compliance with the tax legislation.

Chart 4



Flow meters in the beverage industry

Like in many other countries, the sale of beverages deserves constant attention from the tax authority in Brazil. In 2005, beer sales in the domestic market increased by around 6%, but the corresponding tax revenues increased by around 15%. This performance can be attained, partly, as a result of the mandatory use of flow meters at the plants. The purpose of this measure was to curb tax avoidance in a sector that is normally difficult to control. Breweries are the first to use the new equipment and they were chosen because they account for approximately 70% of the tax revenues obtained from the beverage sector, which has a turnover of more than 7 billion dollars a year. In the sixty breweries that operate in the country, the tax authority keeps a watch on an 8.5 billion liter annual production in real time, checking whether the volume produced matches the amounts invoiced. The same control will soon be applied to soft drink manufacturing plants.

The systems installed at the plants are flow meters and devices for control, registration, recording and remote transmission of information to the Receita Federal. Partnerships between the tax authority and the National Institute of Metrology and Industrial Quality (Inmetro -Instituto Nacional de Metrologia e Qualidade Industrial), the Federal University of Santa Catarina (UFSC-Universidade Federal de Santa Catarina) and the Technological Research Institute of the State of São Paulo (IPT-Instituto de Pesquisas Tecnológicas do Estado de São Paulo) enabled the development of technical specifications, and operational and safety requirements for the new pieces of equipment, all of which -like the procedures for installation and approval- are subject to the regulations of the Receita Federal.

The measure is being well received by breweries, which have defrayed costs estimated to amount to approximately 5 million dollars for the acquisition and installation of equipment. Brewers consider that the impact of control will be positive, since the industries that benefit from tax avoidance will not be able to maintain their prices. The National Union of Breweries expects competition to be leveled on a fair basis.

However, it is not sufficient to install meters for the measure to be effective. Therefore, the tax authority is taking all the necessary precautions so that the project is successful. The Receita Federal has signed technical cooperation agreements with the states of the federation for the installation of flow meters in breweries, as well as to promote the exchange of information and the provision of mutual

assistance for the oversight of the sector's compliance with tax obligations. These agreements are in the interest of both parties and they are essential to allow the tax authority to follow the production and sale of beer.

Cigarette production control and tracking system

The Secretariat of the Receita Federal intends to install in 2006 a Cigarette Production Control and Tracking System at the facilities of national manufacturers, which is expected to be effective in fighting tax evasion in the cigarette manufacturing sector, which currently has a negative impact on tax revenues of approximately R$ 600 million per year. In addition, another R$ 750 million worth of taxes are evaded as a result of smuggling from other countries. This accounts for an annual loss in tax revenues of around R$ 1.35 billion.

Considering the obligation to affix the stamp to cigarette packages produced by manufacturing plants, the Secretariat of the Receita Federal is developing, in conjunction with the Mint of Brazil (state-owned company responsible for making the control stamp), a project for an Integrated Cigarette Production Control and Tracking System, the purpose of which is to enable the following:

- control of cigarette production at the time of manufacturing, making it mandatory to install automatic counters at cigarette manufacturing facilities, which is provided for under Brazilian legislation;
- greater security for the control stamp affixed to the cigarette package, by using new technologies for easy detection by the Receita Federal auditors in their examination work;
- tracking the control stamp by means of a code from manufacturing at the Mint, through delivery to the Secretariat of the Receita Federal, through attachment to the cigarette package by the manufacturer, to final destination, that is, the establishment to which the manufacturer sends the product for sale, and up to the applications for reading and decoding by means of optical readers that can be attached to the notebook computers of the Receita Federal auditors;
- access to information contained in the above-mentioned system by the Secretariat of the Receita Federal, enabling remote control and monitoring of the provision of stamps, production of cigarettes and trademarks, as well as the possibility to cross such information with other economic

and fiscal data, like revenues, debits declared, compensations and supplier invoices for materials used in the production of cigarettes.

The Cigarette Production Control and Tracking System are entirely based on the control stamp, which contains an invisible electronic code inserted during the manufacturing process at the Mint. By means of a reader installed in the cigarette manufacturer's packaging facilities, the code is validated when the stamp is affixed to the package, recording all the information that is relevant for the tax administration. The System is an integrated solution, with unique features, the main support of which is the stamp -without it, the system would not be feasible. All the stages of the process flow mentioned above are based on the manufacturing, coding, distribution, validation and release to market of the product to which the control stamp is affixed.

This ensures the monitoring of cigarette production in Brazil and, consequently, of the level of tax revenues, allowing expeditious and effective action on the part of the Secretariat of the Receita Federal and the provincial Finance Secretariats -on account of the fact that they share information, like with the flow meters in the beverage sector- upon indications of irregularities during the process or in connection with the main offenses currently committed by national cigarette manufacturers, namely, failing to use stamps or using fake ones; failing to declare income or to issue invoices; differences between the amounts recorded in the books and those declared before the Receita Federal; non payment of taxes or payment of amounts lower than those actually due; omissions or errors in the information submitted to the Receita Federal.

Examination and bank secrecy

Fiscal secrecy and bank secrecy were created to protect citizens, but they may compromise auditing actions on criminals. The Receita Federal has tried to broaden legal support to investigate illegal transactions. The 1988 Brazilian Constitution permitted access by agents of the Receita Federal to financial information on taxpayers, but in 1994, the High Court of Justice (STJ) prohibited the delivery of financial information in the hands of the Central Bank to the tax authority. The situation was reversed when complementary laws were passed by the National Congress promoting certain changes to the Tax Code, and the exchange of financial and fiscal information was resumed.

With the new legislation, tax authorities and agents of the National Government, the States, the Federal District and Municipalities can examine documents, books and records of financial institutions, even those referring to deposit accounts and financial applications, in the context of an administrative or fiscal proceeding underway. In addition, the law provides for compliance by the Executive, in terms of timing and amounts, with the criteria according to which financial institutions must report to the Receita Federal the financial transactions made by users of their services.

Declarations - DIMOB and DECRED

Regulations were also passed with a view to introducing the use of new declarations in Brazil to improve the level of information that the Receita Federal receives about taxpayer transactions, which may be extremely valuable to cross information and to identify income that may have gone unreported. For example, in 2003, the Declaration of Credit Card Transactions (Decred) was established, the filing of which is mandatory for credit card operators. The said operators are under the obligation to declare the total monthly aggregate amount spent by the taxpayer –whether an individual or a legal person. This measure applies to monthly amounts spent in excess of R$ 5,000 (around US$ 2,300) in the case of individuals, and R$ 10,000 (around US$ 4,600) in the case of legal persons.

This Declaration allows the tax authority to have access to information about credit card transactions, which is a means of payment that is increasingly being used in Brazil. In fact, the comparison of this information with the economic and fiscal data internally available is a powerful instrument that allows the tax authority to find events of non-compliance with tax obligations. The information about payments and transfers that was addressed first was that referring to cases which are considered unjustifiable (that is, taxpayers that paid or collected significant amounts, but who did not file their returns or declared that they had made no transactions at all, or, also, taxpayers whose records were considered inadequate or cancelled). Overall, 1,040 taxpayers will be examined, 374 of which are individuals and 666, legal persons.

Also in 2003, the Declaration of Real Estate Transactions was established (Dimob), which must be filed by construction companies or companies partnered with them to construct on their land, who sell houses on their own account, and real estate brokers and managers who act as intermediaries in real estate purchase, sale or rental transactions. The Declaration identifies buyers or persons signing real estate rental contracts,

in addition to the date and amount of the transaction. Based on information about economic transactions made by third parties –individuals or legal persons- obtained through the Dimob, the SRF is able to identify events of non-compliance with tax obligations. The income derived from real estate rentals is subject to tax and is among those that pose the greatest risk of evasion. Also transactions relative to the sale of real estate sometimes go unreported to the SRF, because they may have been made with funds that were not declared to begin with, the deed being executed after the statute of limitation has dated. In addition, the data contained in the Dimob may be used as one of the criteria to select taxpayers for examination.

In the year in which the Declaration started to be filed, approximately 750 thousand transactions were reported, relative to 740 thousand taxpayers. In terms of rentals, the amounts reported add up a total of approximately R$ 6 billion. In the Declarations filed in 2003, the real estate purchase and sale transactions reported amount to approximately R$ 18 billion, with payments, in calendar year 2002, of almost R$ 8.5 billion.

CNPJ and CPF for foreigners

Since 2002, it is mandatory for all foreigners –individuals or legal persons- that own real estate, aircraft and vessels in Brazil to be registered with the Receita Federal. It was necessary to adopt this measure precisely to identify the persons that made transactions in Brazil but who did not appear in our data bases because they were foreigners.

C. Information Exchange and Cooperation Measures.

Another important line of action refers to the exchange of information and cooperation with other tax administrations and related entities. Particularly in a federal country, where States administer the main VAT, the exchange of information between the federal tax authority and the provincial ones can be of great value in fighting tax evasion. Likewise, much has been done in terms of joint action with the Federal Police to fight smuggling. It is worth mentioning that the Secretariat of the Receita Federal has signed more than 200 cooperation agreements with different entities for information exchange.

Also worth mentioning is the creation of a synchronized registry to enable information sharing among the tax administrations at the national, state and municipal levels, and integration with other agencies involved in the process of registering companies. The Synchronized Registry seeks

integration, simplification and standardization of obligations relative to the registration process at the three levels of government and to expedite procedures for registration and data modification in the registry. The Synchronized Registry will enable an integrated monitoring of the taxpayer by the various tax authorities, avoiding situations in which, for example, the taxpayer may have a different status in the registries of the different levels of government -active for the Receita Federal and not active for the provincial tax authority or vice versa. The project brings about clear benefits for taxpayers, who, instead of going to several government agencies to register their business or make changes in their registration, can go to a single place. As for tax administrations, integration will also entail lower costs in the long term, since duplication of work and incompatible systems will be eliminated. This will allow a more effective exchange of information among tax authorities, joint and coordinated action, and a stronger fight against tax evasion and avoidance.

D. Other General Legislative Measures with an Impact on Tax Evasion.

Provisional Contribution on Financial Movements (CPMF)

One of the most important legislative changes made in the last few years in Brazil was the introduction, in 1997, of the Provisional Contribution on Financial Movements (CPMF - Contribuição Provisória sobre Movimentação Financeira), succeeding the Provisional Tax on Financial Movements, initially introduced in 1994. In addition to accounting for significant revenues[3] at a very low administrative cost, the CPMF is one of the few taxes that reach the informal economy, significantly increasing the chances of detecting illegal transactions by criminals. The tax is levied only on bank debits and the current rate is 0.38%. Since the banking system in Brazil is quite advanced and the economy is quite dependent on bank transactions (as a result of the years of hyperinflation, when having cash for just a few days entailed the risk of losing almost its entire value), the contribution has been successful from the viewpoint of productivity. In addition, it appears to be adapted to the new reality of commerce and electronic transactions, where, very often, only the trace of the money is seen by the tax authority, in particular when there is no movement of physical goods.

[3] In 2005, the CPMF raised approximately 1.3% of GDP, with a rate of 0.38%, which is considered quite low.

Even if it is liable to be criticized from the viewpoint of economic efficiency, the advantages it presents from an administrative perspective have made the CPMF a vital element for the control activities of the Receita Federal. In fact, although "provisional", the contribution is being successively extended by the National Congress. Data obtained by crossing information from the CPMF (indicating taxpayers' financial movements) and from the income tax returns of individuals and legal entities (in an operation called "Incompatible Financial Movement") show that the movements by individuals and legal entities that claim to be tax exempt or have failed to file their returns actually account for hundreds of billion Reals. The operation, initiated in 2001, finished in 2003, with the completion of 5,038 examination procedures and fiscal credit for R$ 7.7 billion. After that operation and its significant results, the information about financial movements was included in the systems for selection of taxpayers for examination and preparation of fiscal procedures.

Since it is the only tax that reaches the informal or illegal economy, which, to become operational, usually depends on the banking system or the so-called "money laundering" activities, the CPMF can, in practice, be fairer than traditional income taxes, which are mostly evaded by the wealthier, who have sophisticated tax planning mechanisms and impose high examination costs on the State.

Integration with social security revenues

At the moment, a process of integration between the Secretariat of the Receita Federal (which administers both tax and customs revenues since 1968) and the Secretariat of Social Security Revenues (which administers social security contributions) is under consideration. This integration process seeks to optimize material and human resources, reduce operating costs, simplify processes and integrate service, control and information technology systems. In the case of good taxpayers, this will simplify their tax obligations and will allow them to interact with a single representation of the federal tax authority, reducing time and costs. On the other hand, this measure is another hard blow to evaders, since the integration of the tax authorities' data bases will increase the visibility of their transactions. Integration is seen as the ideal form of management. However, while full integration is not yet a reality, the process of information exchange between the Receita Federal and the Secretariat of Social Security Revenues (Secretaria de Receitas Previdenciárias) is already quite advanced.

4. FINAL REMARKS

As shown, the Brazilian experience has been characterized by several changes in the legislation made in the last few years. Undoubtedly, these changes had positive effects in terms of reducing tax evasion and avoidance, and contributed to improving the effectiveness of the tax administration, which is now more able to collect according to its potential.

All these changes to the legislation would not have been possible if the Receita Federal were not always involved in government decisions, permanently working with the Ministry of Finance and congressmen. Thanks to its professionalism and to the results delivered to society, the Receita Federal has gained the necessary support from authorities to give its opinions about tax policy and related issues. In addition, being a respected institution, it has succeeded in executing agreements and internal protocols for cooperation and information exchange with other government entities. With this, the Brazilian tax administration has sought to increase the perception of risk on the part of non-compliant taxpayers, and has tried to increase collection via greater efficiency in fighting evasion.

The changes presented here marked a turning point in Brazilian economic policy. The most recent measures tend to improve the efficiency of both the administrative machinery and the economy as a whole. It is our expectation that other tax administrations can draw important lessons from the legislative measures discussed here, which are part of the Brazilian experience. It is true that each nation is different and there are no ready-made solutions for their problems. However, out of all that has been said, it is possible to draw the conclusion that changes in the legislation can be an important instrument for tax administrations, provided that the measures adopted are transparent and hit the target of tax evasion and avoidance, which harm society as a whole.

TOPIC 3

INTERNATIONAL COOPERATION AS A TOOL FOR ACHIEVING POTENTIAL COLLECTION

Lecture

TOPIC 3.

INTERNATIONAL COOPERATION AS A TOOL FOR ACHIEVING POTENTIAL COLLECTION

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I. INTRODUCTION

The thesis of this General Assembly is that the collection of the total amount of tax liabilities actually owed to a national government is a dynamic variable (hence, the designation as “potential” collection), which is dependent, in turn, upon dynamic variables. These variables fall into two classes: those found in the internal environment of the nation in which the tax administration operates (and which are either legal or administrative); and those that are consequences of the international environment (which may also be legal or administrative mechanisms).

In regard to this latter class of variable, it has become obvious to fiscal authorities that globalization – the increasing integration of economies and trade across national boundaries – causes, or at least should cause, administrative strategies aimed at optimizing the collection of tax liabilities. Globalization inevitably forces a tax administration to pay careful attention to the international environment, and makes it beneficial to enhance its relationships to other revenue authorities in order to address the critical challenges that confront the tax administration.— As noted in the syllabus for this session, the critical challenges are two-fold:– to prevent an unwarranted erosion of the tax base, and to facilitate legitimate business activities that promote the national economic welfare.

Three times in 2005 the Commissioner of the United States Internal Revenue Service, Mark Everson, addressed the United States Congress on the "tax gap", the US term which roughly parallels the topic of this conference, "potential collection". In his recent testimony in October of 2005, before the Subcommittee on Federal Financial Management, of the United States Senate Committee on Homeland Security and Governmental Affairs, Commissioner Everson identified the necessity of international cooperation as a key component of the United States' efforts to address issues relating to the tax gap and potential collection.– International cooperation, worked out in a variety of venues, is a *sine qua non* of effective tax administration in our view.

More recently, in a December 2005 interview with major U.S. tax publications, Commissioner Everson stated our charge for 2006 – to increase the focus in the Internal Revenue Service's agency-wide strategic plan to better combat abusive tax practices involving international elements, in conjunction with a more thorough utilization of technological advances.

Stepping back briefly in time, in order to set out the context of these ideas, in July 2004 IRS announced its updated 2005-2009 strategic plan, which included three key IRS goals: the improvement of taxpayer service; enhancement of tax law enforcement; and modernization of IRS through its business processes and technology. Commissioner Everson considers the additional 2006 emphasis on IRS scrutiny of tax strategies involving international elements to be an improvement of IRS 's existing strategic goal of enhancing our tax law enforcement efforts. The added attention to cross border, tax-related transactions is to ensure that international transactions are complying with existing tax laws. This is because we are increasingly concerned about

international operations and the globalization of all tax issues, both those in the corporate arena and, to an increasingly large degree, those arising with individuals. IRS has identified a number of tax avoidance schemes involving foreign currencies, offshore tax havens, and the use of non-U.S. banks to avoid reporting income. We have already taken action against some practices that may have international elements to them, through the use of insights developed within many of the relational frameworks described subsequently in this paper.

The following two sessions of our program will address two important and specific areas of international cooperation; namely, the exchange of information and the import of harmful tax practices. What are considered in this presentation are three other, more general activities of international cooperation that are just as important for a tax administration to consider, and perhaps participate in, in confronting the challenges of the international environment. These may be topically categorized as International Forums, Multilateral Exchanges, and Horizontal Technical Assistance. The last part of this presentation will then turn to practical activities of international cooperation, as illustrated in the experience of the United States.

II. INTERNATIONAL FORUMS

In addressing the role of International Forums in promoting effective tax administration, the more comprehensive frameworks for international cooperation will be considered first. These would be the organizations with larger and more widespread memberships or participations. Thereafter, attention will be directed to those frameworks with more limited or focused interests.

A. International Tax Dialogue

First to be considered is the International Tax Dialogue. The International Tax Dialogue (ITD) is an initiative of the staffs of the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD), and the World Bank, in cooperation with the United Nations, to better discharge their institutions' mandates by facilitating increased cooperation on tax matters among governments, international tax organizations and others with an interest in tax matters. The ITD aims to facilitate dialogue, to share good practices and pursue common objectives in improving the functioning of national tax systems.

The ITD was developed in the context of the Monterrey Financing for Development Conference call for more international dialogue on tax matters. The underlying concept of the ITD is that an increasing dialogue and a corresponding strengthening of national tax systems will in turn assist the mobilization of tax revenues for development. The ITD recognizes the importance of developing practical means of pursuing dialogue on these issues in ways that minimize the need for additional resources, while maximizing gains for all countries. The ITD's approach is to build on the strengths of existing organizations. A letter outlining the ITD's role, current activities and an invitation to participate was issued in July 2004 to all 184 member countries of the IMF and World Bank. Responses to the invitation have been very positive, particularly from developing countries eager to have a global mechanism for dialogue. More than 70 countries have responded directly to the letter and provided contact information to facilitate further dialogue.

A key objective for the ITD is to establish a clearer focus on technical assistance on tax matters. To facilitate information sharing between providers of technical assistance and recipient countries, and in turn to better co-ordinate such activities, an internet based database with a range of search facilities was developed. The database was initially implemented early 2004. The objectives of the database are to: (1) facilitate access by country officials to relevant information, with the objective of improving their decision-making and use of available technical assistance; (2) facilitate an enhanced level of co-ordination between the participating organizations and thereby minimize any duplication of effort; and (3) provide a 'whole country' view on proposed technical assistance over the short/medium term, in order to assist the participating organizations in longer range planning for future technical assistance.

The ITD database currently contains details of over 660 technical assistance/policy dialogue activities. During an initial pilot phase, entries were provided only by the IMF, OECD and World Bank. The facility is now being expanded to other providers of technical assistance.

As a result, the Ministries of Finance or tax administrations of a number of countries have already begun sharing their knowledge and experience with peers through the web site of the ITD: Australia, Canada, Chile, France, Japan, Ireland, Mexico, Netherlands, New Zealand, Norway, Singapore, Spain, United Kingdom, and United States. For OECD countries, work will continue through the Forum on Tax Administration (which will be discussed subsequently in this

presentation) to facilitate all countries making at least a basic level of information available. For non-OECD countries, marketing continues in all outreach events and through IMF and World Bank liaison with client countries. Furthermore, expanding partnerships with international and regional organizations are expected to have a positive effect in encouraging countries to share information with peers.

B. CIOTA

The Committee of International Organizations of Tax Administrations (CIOTA) is an association of regional and international tax organizations – an association which has been created to provide a forum for the co-operation, coordination and exchange of experiences, knowledge, information, activities and best practices on tax matters among its member organizations.

In June 2001 five regional international tax organizations cooperated in convening (in Canada) an international conference entitled "Tax Administrations in an Electronic World." Subsequent to this meeting the heads of the five co-sponsoring organizations proposed the creation of a "Steering Group/Council of International Tax Organizations," which would consist of the Secretariats of these organizations. These organizations were the Commonwealth Association of Tax Administrators (CATA), the Inter-American Center of Tax Administrations (CIAT), the Centre de Rencontres et d'Études des Dirigeants des Administrations Fiscales (CREDAF), the Intra-European Organisation of Tax Administrations (IOTA) and the Organization for Economic Cooperation and Development (OECD). A formal name for the organization was established – "The Committee of International Organizations of Tax Administrations" (CIOTA) and a mission statement and listing of activities approved. The primary function for the organization is to provide a forum for the co-operation, coordination and the exchange of experiences, knowledge, information, activities and best practices on tax matters among the member organizations. The African Association of Tax Administrators (AATA), The Study Group on Asian Tax Administration and Research (SGATAR) and the Caribbean Association of Tax Administrators (COTA) also joined the committee during 2002.

More specifically, the objectives of the CIOTA are:

- To convene meetings of senior representatives of regional tax organizations to exchange ideas and experiences. These meetings are convened periodically and ideally will be held in

conjunction with international tax organization conferences and assemblies;
- To facilitate the availability of information and the exchange of information related to the overall improvement of the capabilities of tax administrations by fostering co-operation among member organizations;
- To keep members up-to-date with the developments within CIOTA by circulating reference papers of common interest;
- To facilitate global meetings of member states regarding relevant tax themes;
- To develop and enhance the relations among the international organizations and between national tax authorities;
- To consult on proposed and existing activities of the regional and international tax organizations so as to avoid duplication and redundancy.

C. The United Nations

For many years the United Nations (UN) regularly convened an Ad Hoc Group of Experts on International Cooperation in Tax Matters. Among other things, this group considered issues arising under the 1980 United Nations Double Tax Convention. In November 2004, after many months of discussion, the UN agreed to create a Committee of Experts on International Cooperation in Tax Matters, to replace the existing UN Ad Hoc Group.

The creation of the Committee of Experts bears a resemblance to the ITD in that it must be seen in the context of the call made at the 2002 Monterrey Conference on Financing for Development for enhanced international dialogue between national tax authorities and multilateral and regional bodies dealing with tax issues. The Committee of Experts consists of 25 experts, selected by the Council from experts nominated by governments, to serve four-year terms, with a view to equitable geographical distribution representing the five regions of the world, and different tax systems. The new Committee is expected to meet annually in Geneva, and held its first meeting December 5-9, 2005.[1] The Committee is not an intergovernmental body since the experts, although nominated by their governments, are acting in as expert, not an official, capacity.

[1] The composition of the UN Committee of Experts was announced in July 2005 during the ECOSOC meeting. As indicated in U.N. Secretariat's note E/2005/9/Add.1, the 25 members are:

- Mr. Moftah Jassim **Al-Moftah** (Qatar)
- Mr. Bernell L. **Arrindell** (Barbados)
- Mr. Noureddine **Bensouda** (Morocco)
- Ms. Rowena G. **Bethel** (Bahamas)
- Ms. Patricia A. **Brown** (United States of America)
- Mr. José Antonio Bustos **Buiza** (Spain)
- Ms. Nahil L. Hirsh **Carrillo** (Peru)
- Mr. Danies Kawama **Chisenda** (Zambia)
- Mr. Paolo **Ciocca** (Italy)
- Mr. Andrew **Dawson** (United Kingdom of Great Britain and Northern Ireland)
- Mr. Talmon de Paula **Freitas** (Brazil)
- Mr. Harry Msamire **Kitillya** (United Republic of Tanzania)
- Mr. Frank **Mullen** (Ireland)
- Mr. Kyung Geun **Lee** (Republic of Korea)
- Ms. Habiba **Louati** (Tunisia)
- Mr. Ronald Peter van **der Merwe** (South Africa)
- Mr. Dmitry Vladimirovich **Nikolaev** (Russian Federation)
- Mr. Pascal **Saint-Amans** (France)
- Mr. Serafin U. **Salvador**, **Jr.** (Philippines)
- Mr. Erwin **Silitonga** (Indonesia)
- Mr. Stig B. **Sollund** (Norway)
- Mr. Yoshiki **Takeuchi** (Japan)
- Mr. Robert **Waldburger** (Switzerland)
- Mr. Armando Lara **Yaffar** (Mexico)
- Mr. Zhiyong **Zhang** (China)

The new Committee has been given a wide mandate. The Committee is expected to:

(i) Keep under review and update as necessary the United Nations Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries;

(ii) Provide a framework for dialogue with a view to enhancing and promoting international tax cooperation among national tax authorities;

(iii) Consider how new and emerging issues could affect international cooperation in tax matters and develop assessments, commentaries and appropriate recommendations;
(iv) Make recommendations on capacity-building and the provision of technical assistance to developing countries and countries with economies in transition;
(v) Give special attention to developing countries and countries with economies in transition in dealing with all the above issues;
(vi) The Committee shall annually submit a report to the Economic and Social Council at its substantive session (usually held in July), to be considered under the item entitled “International cooperation in tax matters”;

Other International Forums may be productively considered along the lines of two general classifications, geography and economics.

D. CIAT

CIAT itself is a primary example of a largely geographically organized forum. The original intent of CIAT continues: to create a forum to assist the tax administrations of the Americas. This intent is carried out as CIAT pursues three specific strategic objectives:

- encouraging cooperation between the member countries to combat evasion and avoidance and every other form of noncompliance with tax obligations;
- stimulating and conducting research on tax systems and tax administrations and, on the basis thereof, adopting guidelines and developing models, promoting the timely dissemination of relevant information, and exchanging ideas and experiences through international events;
- providing technical assistance on taxation to respond to the needs and interest indicated by the member countries, through the execution of technical cooperation activities of the Center, coordination of temporary exchanges of personnel and/or requests for technical officials from other member countries.

The vision of CIAT is that it should strive to constitute the main association of tax administration at the international level, providing the highest quality services to its member countries. The expectation is that it will accomplish this by:

- Allowing the member countries to act in an environment of total mutual cooperation to combat tax evasion and avoidance, and by promoting mutual assistance and bilateral cooperation between Members in an effort to counteract tax evasion and prevent international double taxation;
- Issuing guidelines on tax matters and promoting tax agreements among the member countries;
- Allowing an open forum for the tax administrations to exchange ideas, express concerns and reach solutions on world-wide tax matters;
- Rendering technical cooperation services of excellence, directing and participating in the formulation, execution and evaluation of technical assistance projects, in the tax administrations that allow them, to act with efficiency and effectiveness;
- Performing research works of an innovative nature, always on the forefront to identify trends in the world economy and in technology as they impact tax administration and the tax systems;
- Using and disseminating administrative practices and state-of-the-art technology, and assisting the member countries in the improvement of their tax administrations and systems, by performing comparative analyses of the “benchmarking” type;
- Preparing available models and prototypes of information systems to serve as references for the improvement of tax administration and legislation of the member countries, and which facilitate the identification of solutions in the technical cooperation activities carried out by the Center.
- Disseminating relevant information through General Assemblies, Technical Conferences, Seminars and Publications;
- Developing specialized technical assistance programs relevant to the particular needs and interest of its Members, through apprenticeships and coordination of requests for technical experts; and,
- Collaborating with other organizations (e.g., OECD) as relevant to CIAT’s interest.

Like many other institutions discussed in this presentation, CIAT is not a "Treaty Organization" (in contrast to, e.g., the United Nations, the Organization of American States, or OECD). However, several member countries, including the United States, have granted it "International Organization" status. There are presently about 12 Technical Assistance projects in member countries and these are staffed with tax administration advisors recruited for each project. They are based wherever the project is being delivered. Their salaries are paid through the project contract, and the Inter-American Development Bank (IDB) funds many of these projects. Organizational activities are supplemented with the permanent technical assistance missions from Spain and France. These missions assist CIAT in training programs and technical assistance projects.

Other organizations that are organized largely along geographic lines are IOTA and COTA.

E. IOTA and COTA

The Intra-European Organization of Tax Administrations (IOTA), is a non profit intergovernmental organization, which provides members in the European Countries with an opportunity to improve tax administration. The decision to establish the Organization was made during the Conference of Tax Administrations of Central and Eastern Europe and Baltic Countries (CEEB) held in Warsaw in October 1996. The European Union and nine of its Member States, the International Monetary Fund, the OECD, CIAT and the USA encouraged this decision.

In 1997, IOTA began operations. The Secretariat of the Organization is located in Budapest, the Republic of Hungary. The primary objectives of IOTA are:

- To promote and develop arrangements for strengthened co-operation between the tax administrations of the member countries.
- To support the tax administrations of member countries with the implementation of their modernization programs.
- To encourage the adoption of good practice in tax administration.
- To promote the specific identity of IOTA as a regional Organization of tax administrations in co-operation with other international and regional Organizations.
- To be a body of consultation for members.

At present, IOTA has 36 members: 29 Full Members and 7 Associate Members. In light of the original intention to establish IOTA as a European effort, Full Membership is open only to countries which are European.

The Caribbean Organization of Tax Administrators (COTA) was established in 1971 when its Constitution was ratified. The Constitution was subsequently approved, in October 1972, by the Ministers of Finance of the Caribbean nations, meeting in Trinidad & Tobago. COTA was later absorbed into the Caribbean Community and Common Market (CARICOM) upon its formation in 1973, as a subsidiary institution. The objective of COTA is to establish working relationships and share best practices relative to issues confronting Caribbean tax administrations. It holds a General Assembly every other year, during even years, to consider topics relevant to direct tax administration. As an example of its work, the topics addressed in the last such meeting included:

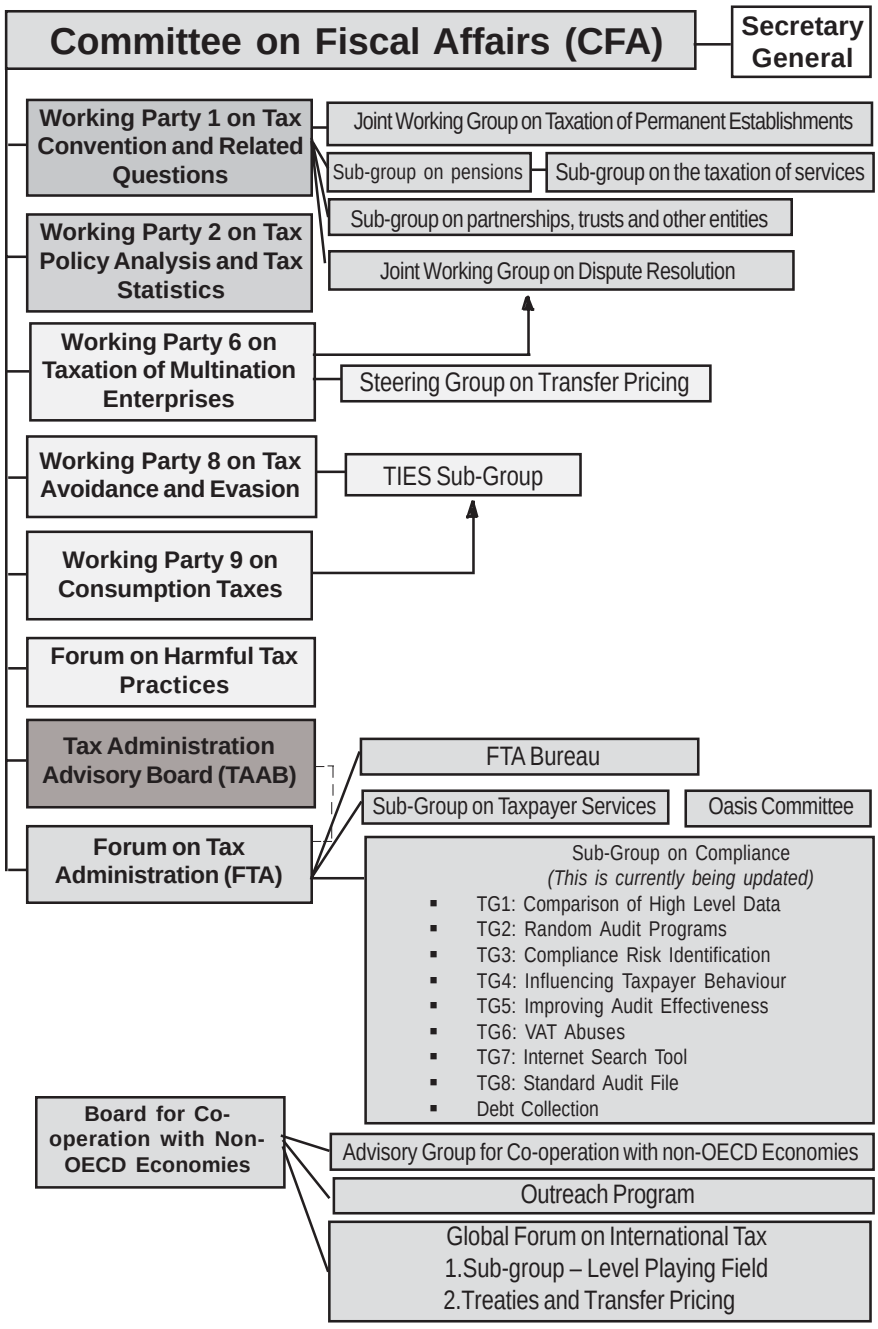
- The Impact of Extra-Regional Double Taxation Agreements on Regional Social Environment and Human Resources
- Business returns processing and introducing new technology
- Managing resources for optimum performance in taxation
- Improving performance in tax administration by managing human behaviour
- Management for correction of unprofessional behaviour and unethical practices in tax administration

F. OECD

Probably the most notable economically based forum that addresses tax administration matters is OECD, an institution whose portfolio covers far more than just fiscal matters. The OECD, largely through the work of its umbrella policy group, the Committee for Fiscal Affairs (CFA), has historically served as a leader in developing standards and guidelines to encourage co-operation in international tax matters. The CFA was established in 1971 to provide a forum for policy makers to discuss international and domestic tax issues.

The CFA's work program is carried out by subsidiary bodies where participants are primarily drawn from OECD countries, consisting of experts drawn from member governments and, in certain cases, non-member economies. The CFA establishes the work programs of these bodies and oversees their implementation. The subsidiary bodies

consist of various Working Parties, Forums, Steering Groups, Sub-Groups and Technical Advisory Groups (TAGs).



These groups have no specific duration and can be terminated by the CFA when their tasks have been completed. However, the Working Parties are more or less permanent, and carry on the principal responsibilities to examine specific taxation topics and provide the CFA with regular progress reports. The CFA and Working Parties typically meet twice per year.

As noted, the mission of the Committee on Fiscal Affairs is to provide a forum for tax policymakers and administrators to discuss current policy and administration issues; to assist OECD countries and non-OECD economies in working to improve the design and operation of their tax systems; to promote co-operation and co-ordination among them in the area of taxation; and to encourage non-OECD economies to adopt taxation practices which promote economic growth through the development of international trade and investment. To achieve these goals the Committee:

- provides a forum for discussions by senior policymakers and tax administrators of matters of both international and domestic tax policy and administrative issues;
- develops standards, guidelines and best practices in areas where international coordination is desirable and monitors the practical implementation of other recommendations;
- promotes a climate that encourages mutual assistance between OECD countries and establishes procedures whereby potentially conflicting tax policies and administrative practices can be discussed and resolved;
- promotes communication between OECD countries and the adoption of appropriate policies to prevent international double taxation and to counteract tax avoidance and evasion;
- encourages the elimination of tax measures which distort international trade and investment flows;
- provides OECD countries with internationally comparable tax statistics and comparisons of the major taxes used throughout the OECD area, and provides strategic analysis of important tax policy and administration issues for use in publications, briefs, conferences and the like;
- encourages participation by non-OECD economies in the Committee's work and in achieving the wider application and implementation of OECD developed guidelines and best practices;
- encourages non-OECD economies to adopt the standards, guidelines and best practices developed by the Committee, thereby assisting their integration into the international economy;

- promotes and develops strategic partnerships with regional tax and other international organizations; and
- co-operates with other Committees of the Organization.

In striving to attain these goals, the CFA contributes to the OECD objective of promoting the development of international trade and the free movement of capital and labor, and thereby facilitate the development of national economies and of the global economy.

Effective January 2004, the CFA reorganized its Secretariat staff and re-titled it the “Centre for Tax Policy and Administration” (CTPA). The CTPA staff carry out much of the hands-on working of drafting and documenting the policy and administrative discussions and decisions made by CFA and its subsidiary bodies. This work establishes the visibility of the policy and administrative work in the international community.

G. Forum on Tax Administration

A discrete institutional subset of the work carried on by OECD is the Forum on Tax Administration.The Forum on Tax Administration (FTA) was created in July 2002 by the Committee on Fiscal Affairs with the aim of promoting dialogue between tax administrations and identifying good tax administration practices. These objectives are based on, and reflect, the high degree of commonality of the systemic features of taxation in OECD member countries. The potential value of sharing information on countries’ experiences in their efforts to improve taxpayers’ compliance, taxpayer service and administrative efficiency in a rapidly changing environment is obviously immensely enhanced by these common features.

The creation of the FTA is intended to help national tax administrations respond to pressure from governments to improve the service they provide to taxpayers, and to secure the revenue base. There has been widespread recognition that good compliance, which is the overriding objective of all tax administrations, requires advancing simultaneously on agendas of both taxpayer service and tax enforcement. Citizens have a right to expect tax authorities to strive to make the payment of tax as painless as possible. But honest taxpayers also expect that tax administrations will enforce the law and that non-compliance with the law will be identified and dealt with appropriately.

The work of the FTA is carried to a large extent by two specialist Sub-groups. The Compliance Sub-group exists to provide a forum for members to share experiences and knowledge of compliance approaches in OECD member countries to implement good practice in compliance activities and administration, both domestically and internationally. Its work includes: (1) periodical monitoring and reporting on trends in compliance approaches, strategies and activities; (2) consideration and analysis of member compliance objectives, strategies to achieve those objectives and the underlying behavioral compliance models and assumptions used; (3) consideration and analysis of member compliance structures, systems and management, and staff skills and training; and (4) creation of “best practice” papers on emerging trends and innovative approaches.

The Taxpayer Services Sub-group exists to provide a forum for members to share experiences and knowledge of approaches to taxpayer service delivery, in particular through the use of modern technology. In this context, it undertakes to: (1) periodically monitor and report on trends in taxpayer service delivery, with a particular focus on the development of electronic/online services; (2) examine ways to promote the uptake and use of electronic services by revenue bodies; (3) examine options for cross-border administrative simplification and consistency; and (4) assist, as appropriate, other groups of the CFA.

The FTA is expected to produce a variety of other outputs in the coming years. Among these are guidance on compliance risk management techniques, guidance on strategies for improving tax debt collection, information regarding VAT abuses, guidance on tax audit data standards, and practical guidance on approaches for determining the best mix of channels for taxpayer service delivery.

In its relatively short lifetime, the FTA has become an increasingly effective mechanism for exchanging views and sharing productive tax administration practices among member countries – and also, more generally, to non-members through the OECD´s extensive outreach efforts. The work of the FTA will continue to facilitate the development of a system of good practice materials that will be made available to assist tax bodies (both OECD and non-OECD) to enhance their administrative programs.

H. FATF

A group that is loosely related to OECD and whose activities are significant to tax administration is the Financial Action Task Force (FATF). FATF is an inter-governmental body, not a formal and official organization, whose purpose is the development and promotion of policies, both at national and international levels, to combat money laundering and terrorist financing. Thus, it is less involved in administration, and is more of a policy-making effort which works to generate the necessary political will to bring about national legislative and regulatory reforms in the relevant areas.

In response to the growing concern over money laundering, FATF was established by the G-7 Summit that was held in Paris in 1989. Recognizing the threat posed to the banking system and to financial institutions, the G-7 Heads of State and the President of the European Commission convened the Task Force from the G-7 member States, the European Commission, and eight other countries. The Task Force was given the responsibility of examining money laundering techniques and trends, reviewing the action which had already been taken at a national or international level, and setting out the measures that still needed to be taken to combat money laundering. In April 1990, less than one year after its creation, the FATF issued a report containing a set of Forty Recommendations, which provide a comprehensive plan of action needed to fight against money laundering.

During 1991 and 1992, the FATF expanded its membership from the original 16 to 28 members. Since then FATF has continued to examine the methods used to launder criminal proceeds and has completed two rounds of mutual evaluations of its member countries and jurisdictions. It has also updated the Forty Recommendations to reflect the changes which have occurred in money laundering and has sought to encourage other countries around the world to adopt anti-money laundering measures. In 2001, the development of standards in the fight against terrorist financing was added to the mission of the FATF.

FATF monitors members' progress in implementing necessary measures, reviews money laundering and terrorist financing techniques and counter-measures, and promotes the adoption and implementation of appropriate measures globally. In performing these activities, FATF collaborates with other international bodies involved in combating money laundering and the financing of terrorism. For example, in its meeting of October 2005, FATF launched an ambitious project, in partnership with the Asia/Pacific

Group on Money Laundering, to explore the symbiotic relationship among corruption, money laundering and terrorist financing and how the prior experience of FATF's efforts in AML/CFT (i.e., Anti-Money-Laundering and Combating the Financing of Terrorism) can best be used to combat these combined threats. FATF works closely with seven similar regional groups, including the Caribbean Financial Action Task Force, and the Financial Action Task Force of South America Against Money Laundering (a/k/a GAFISUD)[1], the South American regional body,

FATF does not have a tightly defined constitution, nor an unlimited life span, and reviews its mission every few years. FATF has been in existence since 1989, and its constituent governments have agreed that its current mandate should extend through the end of 2012. However, it will only continue to exist and perform its functions after this date if the member governments agree that this is necessary.

III. MULTILATERAL EXCHANGES

International Forums are often generally concerned with a broad array of fiscal matters, and thus their work may or may not affect tax administration directly. The participation of a tax administration in such a Forum may be relatively superficial and merely conceptual, largely reflecting only the national commitment to the institution. By contrast, the activity of a tax administration in the category of Multilateral Exchanges may encompass the work of tax administration in a more focused and practical effort. Consequently, there is a wider variety of examples of such activities that reflect international cooperation among tax administrations.

A. Industrywide Exchanges

An Industrywide Exchange is a meeting of tax treaty or TIEA partners in an effort to promote understanding of the worldwide operations of selected major industries, for example, banking or pharmaceutical development / manufacturing. The principal objective of such an exchange is to secure comprehensive data on worldwide industry practices and operating patterns. This information enables a more effective and knowledgeable review of the tax returns of multinational enterprises.

1) Grupo de Acción Financiera Internacional sobre Lavado de Dinero.

The scope of an industrywide exchange is established by an exchange of letters between the Competent Authorities of the tax treaty or TIEA partners. Generally, the initiating Competent Authority will designate a Designated Representative to coordinate the industrywide exchange. The Industrywide Exchange is then conducted by tax officials of each country, who meet periodically to:

1. discuss current industry events of mutual interest;
2. jointly explore common issues;
3. pool resources for special studies
4. discuss comparative methodology in establishing arm's length standards;
5. conduct seminars on major international issues; and
6. cooperate on new and emerging issues.

During an industrywide exchange, taxpayers are not discussed and no taxpayer information is exchanged. Any request made by a treaty partner for specific taxpayer information is handled in a bilateral fashion, in accordance with the exchange of information articles of the relevant tax treaty or TIEA agreement, under the Specific Exchange of Information Program of the relevant countries.

Any information obtained at an industrywide exchange should only be disclosed to those persons whose official tax administration duties with respect to the industry issues requires such disclosure.

B. OECD Tax Inspectors Meetings

OECD Working Parties occasionally hold *ad hoc* meetings of tax inspectors from member countries, to share strategies and experiences regarding the specific matters of tax administration. An example would be a meeting held to address international tax evasion and avoidance schemes. Such a meeting may be attended by 50 or more international tax specialists with expertise in the relevant areas of international compliance, exchange of information and international tax audits from the OECD and major non-OECD economies participating in the meeting.

C. Global Forum on Taxation

The OECD sponsors periodic meeting of the Global Forum on Taxation (GFT), which includes both OECD and non-OECD countries and

jurisdictions, to address matters that have arisen under the project on Harmful Tax Practices. A following session of this CIAT Assembly will undoubtedly speak more specifically to the work of the GFT. The GFT is a follow-up by OECD with non-members in its ongoing efforts to improve transparency, establish effective exchange of information in tax matters and work towards achievement of a level playing field in these areas. The overriding objective of this work is to enhance international co-operation and improve transparency and exchange of information for tax purposes so that all countries are in a better position to be able to enforce their own tax laws.

Over the last several years, the Global Forum has carried out several projects to further these goals. The Global Forum's work on transparency and exchange of information was initiated in 2000 by a working group of OECD and non-OECD countries that produced the Model Agreement on Exchange of Information in Tax Matters released by the OECD in 2002. The Model reflects the high standard of information exchange that the Global Forum wishes to see achieved and it is now being used to negotiate bilateral agreements. The work of that group has been complemented by the work of the Global Forum's Joint Ad Hoc Group on Accounts, which has developed guidance on accounting and recordkeeping requirements for corporations, partnerships, trusts and other entities or arrangements.

There is steadily growing political support for the work of the Global Forum in both developed and developing countries. The G20, a group that accounts for ninety percent of the world's GDP and two-thirds of its population, issued a statement in late 2004 committing the constituents "to the high standards of transparency and exchange of information for tax purposes that have been reflected in the Model Agreement on Exchange of Information on Tax Matters" and calling all countries to adopt the standards. The G20 group "strongly supports the efforts of the OECD Global Forum on Taxation to promote high standards of transparency and exchange of information for tax purposes and to provide a cooperative forum in which all countries can work towards the establishment of a level playing field based on these standards." [2]

2) The members of the G-20 are the finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi-Arabia, South Africa, Turkey, the United Kingdom and the United States. Another member is the European Union, represented by the Council presidency and the President of the European Central Bank. The managing director of the IMF and the president of the World Bank, plus the chairpersons of the International Monetary and Financial Committee and Development Committee of the IMF and World Bank, also participate in the talks as ex-officio members.

- In working towards a level playing field, the Global Forum seeks to set standards in a way that is fair, equitable and permits fair competition between all countries, large and small, OECD and non-OECD. As stated in a recent report, "The underlying objective of the global level playing field is to facilitate the creation of an environment in which all significant financial centres meet high standards of transparency and effective exchange of information on both civil and criminal taxation matters. This is vital to ensuring that countries can obtain from other countries the information necessary to enforce their own tax laws, to ensuring that financial centres that meet such standards are not unduly disadvantaged by doing so, and to ensure~~ing~~ that financial centres that meet such high standards are and remain fully integrated into the international financial system and the global community."

The increasing use of cross-border tax evasion and avoidance schemes is a major challenge for all tax administrations. Such practices can be detected and deterred through effective exchange of information between tax authorities. Participants in the Global Forum have examined the legal mechanisms that facilitate such co-operation and share practical experiences through discussion of case studies illustrating how international co-operation between treaty partners has assisted national tax administrations in the detection and counteraction of tax evasion and avoidance schemes.

D. Seven Country Tax Haven Forum

The Seven Country Tax Haven Forum is an unofficial group of OECD members who meet in a strategic partnership to improve each country's capacity to deal with the risks posed to their tax systems by tax havens. The Forum provides an opportunity to share details of current tax planning arrangements and to explain compliance techniques being employed to address tax haven risk, and otherwise seeks to deal with offshore compliance issues arising from the use of tax havens.

The Forum allows participating countries to display their techniques and databases in the monitoring of promoters, schemes and participants. Generally, these discussions are focused on promoters, or on topics allowing interactive group work, e.g., using case studies for the purpose of harmonizing risk-ranking and the profiling of promoters. This Forum also facilitates the meetings of appropriate personnel from some of the jurisdictions on related issues such as

credit card transactions, wire transfers and other cutting-edge financial schemes and capabilities. The Forum holds an annual general meeting once per year around February/March, and a teleconference every two months.

E. JITSIC

The Internal Revenue Service and the national tax agencies of the United Kingdom, Canada and Australia have created the Joint International Tax Shelter Information Center (JITSIC) to identify, develop and share information and expertise about abusive tax avoidance transactions. Representatives from the four countries work together at the Center, located in Washington, DC, exchanging information and sharing expertise on a "real time" basis.

The intention of JITSIC is to focus on cross border transactions. In recent years the proliferation of abusive tax shelters has evolved to include the creation, structuring and marketing of tax shelters, and investments in shelters, across international borders. These transactions are more difficult to detect and unravel without sharing of information and knowledge by national revenue authorities. JITSIC will initially focus on financial products that are structured, marketed and used to generate abusive tax schemes.

Although JITSIC is not a joint enforcement venture, the information exchanged will assist each member tax authority in determining additional steps to stop abusive transactions. In this regard, JITSIC members will exchange information about abusive tax schemes and will share expertise, experience and practices to combat abusive tax schemes. JITSIC also shares information about transactions that could be developed and promoted within the tax systems of the participating nations.

To combat abusive tax shelters, the US has a multi-faceted strategy in place that focuses on disclosure and transparency. Regulations require promoters to register shelters and maintain lists of investors. They also require investors to disclose their participation in shelters. IRS actively investigates and takes legal and enforcement action to stop promoters of abusive tax shelters. The agency also examines tax shelter investors' tax returns. IRS issues guidance on abusive transactions to advise the public of tax positions that will be challenged. However, shelter promotions and investments that cross international borders are difficult to detect and unravel. The combined detection and analytical

capabilities of JITSIC will better enable IRS and other participating tax agencies to take action against those who go abroad to plan, facilitate or engage in abusive tax transactions. It is expected that participation in JITSIC will enhance each member country's tax shelter strategy.

IV. HORIZONTAL TECHNICAL ASSISTANCE

In order to be effective, it is necessary for a tax administration to secure the revenues adequate for its government to provide the services necessary for the welfare of the state. The United States, along with many other developed nations, has embarked on a program of technical assistance to tax administrations requesting such support. Stable economies require effective systems of tax administration and the IRS views requests for assistance as opportunities to contribute to the strengthening of tax systems and the economies they support. The vision for the effort with respect to each country is to help local officials build into each tax agency modern methods, techniques, procedures, programs, attitudes, and organizations that will continue as a way of life for tax officials and the taxpayer community.

A. OECD Assistance

A broad program of technical assistance in fiscal and tax matters is carried on by OECD. The Board for Co-operation with non-OECD Economies, on behalf of the CFA, oversees the OECD's work program with non-member economies, and provides a framework for engaging non-member economies in an ongoing dialogue on key tax policy and administrative issues. The CFA is involved in a number of activities designed to assist these economies. These activities are carried on in two forms:

- The Global Forum on International Taxation, consisting of a group of networks, dialogues and informal meetings, designed to expose non-OECD economies to OECD standards and guidelines and to provide a forum for dialogue between OECD members and non-members.
- The Outreach Program, consisting of assistance targeted towards specific regions and countries. Specialized seminars and workshops are held at the OECD's four multilateral tax centers (located in Ankara, Budapest, Chonan and Vienna), as well as occasionally at other international venues

B. Other Forms of Assistance

A more generic and multilateral form of Horizontal Assistance is the development for general usage of "model" legal and administrative documentation to articulate common principles and guidelines for the administration of tax systems across borders. Examples of such legal documents would be the UN Model Double Taxation Convention, the OECD Model Tax Convention on Income and Capital, and the CIAT Model for the Exchange of Fiscal Information. Examples of such documents relating to the administrative aspects of international tax cooperation would be the CIAT Model Code of Conduct, or the OECD Manual on the Implementation of Exchange of Information.

Lastly, another possibility of Horizontal Assistance, though sometimes more difficult to arrange due to various legal and logistical constraints, is the assignment of officials to other tax administrations, i.e., secundment of personnel. This could be either for developmental purposes relating to the career targeting of the particular individual, or for the direct benefit of the receiving jurisdiction, because the particular skill-set of the individual is especially necessary or desirable. An example of this possibility is the CIAT Internship. This program has three primary objectives:

- It affords officials the opportunity to familiarize themselves and understand the tax and customs management processes, regulations and procedures used in other member countries;
- It contributes to improving the member countries' processes, procedures and, in general, technical management, by providing the officials training and technical assistance; and
- It promotes a better and more intensive use of resources existing at the tax and customs administrations of the CIAT countries, by promoting bilateral cooperation among the CIAT member countries.

V. PRACTICAL ACTIVITIES

The United States has been actively engaged in all three forms of international cooperation previously described, and for many years. For example, with respect to International Forums, representatives of the Internal Revenue Service attend and actively participate in many of the subgroups of the OECD, and have particularly played leading roles in the OECD Forum on Tax Administration. While IRS staff are only occasional participants in some of the more policy-oriented

international efforts, we have been the principals in those projects that are primarily administrative in nature, such as the FTA and the Technical Advisory Groups that have looked into various electronic commerce issues. And IRS also provides much support to our policy colleagues in the organizations in which a detailed knowledge of the “nuts and bolts” of tax administration is critical, such as FATF.

Similarly, IRS employees are the principal representatives of the United States in the Multilateral Exchanges that focus on administrative matters. IRS has hosted many Industry-wide Exchanges and participated in many others. IRS staff regularly attend the Tax Inspectors Meetings hosted by OECD, and have routinely assisted in the organization of cross-border compliance efforts, including the various tax haven endeavors that “zero in” on tax avoiders. Lastly, much of the Horizontal Technical Assistance provided by the United States to developing economies is carried out through the work of the IRS office of Tax Administration Advisory Services.

Although the following segment of this General Assembly’s broader program on International Cooperation will deal with Exchange of Information, this presentation would be incomplete if it did not address several matters relating to that topic.

First, a truly effective program of international cooperation must be founded upon a sufficient legal basis. Such a sufficient legal basis is only found in a network of tax treaties and/or tax information exchange agreements that give a tax administration the authority and power to share information regarding particular taxpayers and concerning specific transactions. A network of this sort is absolutely necessary because, in the final analysis, the tax administration is only doing its job when it is carefully examining the reporting of taxpayers to ensure that the reporting accurately reflects the actual tax obligations of the taxpayers. And of course the corollary to the careful examination of taxpayer reporting is the assurance, through investigation, that the taxpayers are actually paying their obligations. The United States pursues an active program of treaty and TIEA negotiation, and has at present over 75 tax treaties and TIEA’s in force, with more on the way. Many of the jurisdictions present in this room have such agreements with the United States, enabling them to share information with the Internal Revenue Service.

The legal basis for exchange is more, however, than just the international agreement to do so. There must also exist an adequate internal, domestic legal structure that enables the tax administration to act on behalf of its partner, so that it may obtain and transmit the necessary information, especially upon a request to obtain such information. In support of the statutory scheme, it is important that the judiciary of the country stand behind the tax administration and enforce its effort to gather information, as well as approve of the "competent authority" of the treaty partner's tax administration. And, of critical importance to the United States and many other countries, there must exist internal, domestic confidentiality laws that preserve the due secrecy of taxpayer information and establish appropriate consequences for unauthorized disclosure of such information. The United States has been blessed with the development of an extensive legal structure for, and judicial approval of, tax law enforcement, including enforcement efforts on behalf of treaty partners, and also a carefully-crafted taxpayer confidentiality scheme that holds out significant penalties for unauthorized disclosures of taxpayer information.

In addition to the legal framework, a tax administration must have a variety of resources to support its work of international cooperation. In our experience, it is important to have clearly written internal procedures concerning how to gather information, both domestically and through written requests to other countries and jurisdictions. It is highly beneficial to have the capability of accessing identifiable electronic sources of information through external, public databases, as well as information maintained in internal tax records. Up-to-date internal and external communications systems (phone, mail, fax, e-mail), and adequate facilities of office space and equipment are non-negotiable. An adequate budget for the tax administration, for personnel, supplies, travel and other enforcement costs, a sufficiently educated and motivated staff, and appropriate training of the staff – these, too, are indispensable to an effective program of international cooperation.

Obviously, a necessary subset of the administrative infrastructure is an organized Exchange of Information Program. The requirements for such a program include:

- A designated office as the "competent authority"(CA) under the international agreement, filled by an identified individual.
- Adequate staffing for the CA office, including adequate training and delegations of authority. These personnel must have:

  - Knowledge of the Exchange of Information procedures of tax treaties and TIEA's
  - Knowledge of the tax administration and how it is structured
  - Knowledge of relevant administrative procedures
  - Knowledge of the domestic tax laws affecting the gathering of information
  - Ability to analyze and work with administrative processes
  - Ability to communicate with individuals coming from different cultures
  - Problem resolution skills

- Filing and tracking systems for cases, program history, and policy
- Written policies and procedures
- The authority to direct field personnel to gather information, if necessary
- The ability to modify procedures as necessary to gather information
- The ability to protect information gathered and exchanged
- Legal counsel to advise and defend, as necessary

An Exchange of Information Program covers a variety of functional activities. These activities are often grouped into five categories of Exchange:

- Specific
- Spontaneous
- Automatic
- Simultaneous Examination
- Industry-wide Exchange

The Exchange of Information article in a tax treaty or TIEA ordinarily covers (and provides authority for) each of these five categories. As described earlier in this presentation, an Industry-wide Exchange occurs somewhat sporadically. Similarly, simultaneous examinations may or may not be frequent. The United States has agreements with about fifteen treaty partners to more clearly set forth the procedures employed in carrying on such an activity (an activity which is, by the way, not a "joint" audit). Spontaneous exchanges are also sporadic, when one tax administration discovers information, for example, during an audit, that suggests non-compliance in a treaty partner and then forwards that information to the treaty partner. Automatic exchanges,

by contrast, take place on a more or less annual basis, and comprise an exchange of a mass of data concerning transmissions of passive income, i.e., dividends, interest and royalties.

The most common type of information exchange is that made upon a specific request from a treaty partner. The information requested is routinely the same type of information that is sought in any other audit: bank records, brokerage records, corporate and real estate records, tax return data, information from third party interviews. Such information may, in some cases, be held by the foreign tax administration, but often is in the possession of taxpayers. The request, and the provision, of such information must conform to the legal requirements and obligations set forth in the treaty of TIEA

Finally, perhaps the most critical component of a program of international cooperation that is truly effective is the intangible of a commitment to exchange information. This is the willingness of the tax administration and all of its relevant staff, in addition to the legal authority to do so, to obtain and provide information when requested by its treaty partners. Ultimately, this intangible is most necessary in the staff of CA office – the individual who fills the office of "Competent Authority", along with all the other employees of his or her office – and includes a recognition by those persons of the issues involved in exchanging information and their ability to effectively interact with treaty partner personnel in the effort to obtain available requested information.

VI. CLOSING

As we dialogue in meetings both formal and informal, significant ideas for change can germinate and sprout. Both in and among societies, the conversations and interactions of people enable them to decide on the appropriate course of action necessary to affect their lives and institutions. It is through activity in relationships – that is, the activity of cooperation – that effective government takes root and flowers in its objectives. And it is through their activity in international relationships, such as in this Assembly as well as those described previously in this

Case study

TOPIC 3.1

THE EXCHANGE OF INFORMATION AND ASSISTANCE FOR SECURING AND EXECUTING TAX DEBTS

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CONTENTS: A. Exchange of Information and International Co-operation on Tax Collection.- 1. The increasing importance of exchange of information and collection assistance.- 2. The international legal framework.- 3. Forms of exchange of information.- 4. The basic rules of international information exchange.- 5. The basic rules of international collection assistance.- 6. Recent OECD initiatives.- B. The Administration of Tax Debt Collection Activities.- 1. Introduction.- 2. General principles and approaches applied to frame the survey of country debt collection practices.- 3. 2005 Survey of debt collection practices — Key findings and conclusions.- 4. Summary.

Tax administrations are charged with the responsibility to determine the correct amount of tax due from each taxpayer and to collect that amount. Both the assessment and collection of tax have been made more challenging by the globalisation national economies.

The first part of this paper describes how bilateral and multilateral information exchange and collection assistance mechanisms can help tax administrations meet this challenge. It sets out the relevant international legal framework, the different forms of information exchange and the basic operational rules of international information exchange and cross border collection assistance. It then discusses recent OECD initiatives in this area such as the recent revision of Article 26 of the OECD Model Convention and the OECD's work with offshore financial centres.

The second part of the paper provides a brief summary of recent OECD work to review debt collection strategies and approaches carried out in response to the concerns of a number of OECD member countries about the growing incidence of unpaid taxes. This material has been included to keep CIAT delegates and other observers abreast of the OECD's work and in light of keen interest of tax administrations in the performance of the tax debt collection function.

A. EXCHANGE OF INFORMATION AND INTERNATIONAL CO-OPERATION ON TAX COLLECTION

1. The Increasing Importance of Exchange of Information and Collection Assistance.

The past decades have witnessed an unprecedented liberalisation and globalisation of national economies. Countries have increasingly removed or limited controls on foreign investment and relaxed or eliminated foreign exchange controls. At the same time progress in information and telecommunication technology has made the world a smaller place. As a result, business and financial activities take place in an increasingly borderless world.

While business goes global, tax administrations remain confined to their respective jurisdictions. The exercise of sovereign powers, including tax verification, assessment and collection activities, is generally limited to a jurisdiction's territory. Thus, a tax inspector might only see a small part of the overall activities or investments of a taxpayer operating on a global basis if he relies on domestic sources of information. As a result, tax administrations increasingly rely on co-operation from their foreign counterparts to more effectively administer their national tax laws.

A key element of such co-operation is exchange of information. It is an effective way for countries to maintain sovereignty over the application and enforcement of their tax laws and to ensure the correct allocation of taxing rights between tax treaty partners. Similarly, co-operation in collection assistance is increasingly viewed as an important tool in protecting tax revenue and increasing tax compliance.

2. The International Legal Framework.

There are a number of international legal instruments on the basis of which exchange of information for tax purposes may take place, including:

- Bilateral tax conventions which are generally based on the OECD Model Convention on Income and on Capital or the United Nations Model Convention on Income and Capital.

- International instruments designed specifically for administrative assistance purposes in tax matters such as tax information exchange agreements generally based on the 2002 Model Agreement on Exchange of Information on Tax Matters developed by OECD countries and offshore financial centres, the Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters, or the Model Agreement on the Exchange of Tax Information developed by CIAT.

- Within the European Community, the EC Directive on Mutual Assistance (Directive 77/799/EEC as updated), for exchange of information for VAT purposes, Regulation No 1798/2003 and for excise duties, Regulation No 2073/2004.

- International judicial assistance agreements, such as the Inter-American Convention on Mutual Assistance in Criminal Matters (as extended by the Optional Protocol of May 23, 1992) in cases of tax crimes.

Procedures for providing assistance to foreign jurisdictions may also be established in domestic law. For instance, some countries (e.g. Germany) permit the provision of information to another jurisdiction, subject to certain conditions and safeguards (e.g. reciprocity and confidentiality of information), even in the absence of an international agreement and solely based on their domestic law provisions.

The provisions on exchange of information do not allow for assistance in tax collection in the sense of empowering the competent authorities to use their powers of collection on behalf of the other contracting party. However, they include information exchange for “collection of taxes” and thus information assisting in the collection of domestic taxes can be exchanged between contracting parties. Such information could be useful in cases where a taxpayer is seeking a reduction of the tax assessed on the basis that he has insufficient funds to pay the full amount of tax owed. An exchange of information agreement would enable the tax authority to verify whether the taxpayer had assets abroad.

The development of provisions that permit countries to collect taxes on behalf of their treaty partners has lagged behind the development of provisions for information exchange. The Model Convention for Mutual Administrative Assistance in the Recovery of Tax Claims, which the OECD published in 1981, was not widely used. Historically, the general principle of international tax law was that a country will not assist in the enforcement of the tax claims of another country. Taxpayers may have assets throughout the world, but tax authorities generally could not go beyond their borders to take action to collect taxes. However, with the increased mobility of taxpayers and capital, this principle, also known as the “revenue rule” under common law, is gradually being abandoned. Countries are increasingly willing to engage in assistance in tax collection when certain conditions are met.

Until recently the experience with assistance in tax collection has mostly involved neighbouring countries with strong economic and political ties and which are bound by bilateral or multilateral agreements such as the 1952 Benelux Mutual Assistance Treaty or the first Nordic Convention on Mutual Assistance in Tax Matters. Assistance in tax collection on the basis of bilateral tax conventions was rather limited and the OECD Model Convention did not include an article on assistance in the collection of taxes until 2003. The 1976 EU Directive on mutual assistance for the recovery of claims only covered certain levies, duties and taxes but not VAT or direct taxes.

In an era of globalisation, traditional attitudes towards assistance in the collection of taxes have changed. This change was to some extent influenced by the development of electronic commerce due to the concerns about the ability to collect VAT on such activities. The 1998 OECD report, *Harmful Tax Competition: An Emerging Global Issue*, also highlighted concerns about increased tax evasion if one country

will not enforce the revenue claims of another country. The Report thus recommends that *"countries be encouraged to review the current rules applying to the enforcement of tax claims of other countries and that the Committee on Fiscal Affairs pursue its work in this area with a view to drafting provisions that could be included in tax conventions for that purpose".*

As a result of such concerns, the OECD Council approved in 2003 the inclusion of a new Article 27 on assistance in tax collection in the OECD Model Tax Convention. This Article is optional and may be included in a bilateral convention where each state concludes that, based on a number of factors, they can agree to provide assistance in the collection of taxes levied by the other state. The factors considered include the importance of their cross-border investment, reciprocity, the ability of their respective administrations to provide such assistance and the similarity of the level of their legal standards, particularly with respect to the protection of the legal rights of taxpayers and more broadly human rights. Some countries' laws may not allow or justify this type of assistance.

There are now also a number of other instruments that include provisions on tax collection: Both the Nordic Assistance Convention on Mutual Assistance in Tax Matters and the Joint Council of Europe/OECD Convention include provisions on assistance in tax collection. Furthermore, the EU has developed a Directive on Mutual Assistance for the Recovery of Tax Claims (Directive 76/308/EEC as amended by Directive 79/1071 to cover Value Added Taxes, and as amended by Directive 2001/44/EEC to cover direct taxes as well as taxes on insurance premiums). Finally, there are also bilateral conventions for mutual assistance in the recovery of tax claims (as for instance the Convention between the Netherlands and New Zealand).

3. Forms of Exchange of Information.

The main forms of information exchange are: on request, automatic and spontaneous. These different forms of exchange can be described as follows:

- *Exchange of information on request***.** Exchange of information on request refers to a situation where the competent authority of one country asks for particular information from the competent authority of another contracting party.

- *Automatic exchange of information*. Information which is exchanged automatically is typically information comprising many individual cases of the same type, usually consisting of details of income arising from sources in the source country, e.g. interest, dividends, royalties, pensions etc. This information is obtained on a routine basis (generally through reporting of the payments by the payer) by the sending country and is thus available for transmission to its treaty partners. Normally, competent authorities interested in automatic exchange will agree in advance as to what type of information they wish to exchange on this basis. To improve the efficiency and effectiveness of automatic exchanges of information the OECD has designed initially a standard paper format and a later standard electronic format (known as the OECD Standard Magnetic Format or "SMF"). The OECD recommends the use of the SMF and has also developed a Model Memorandum of Understanding for automatic exchange of information available for use by any country**.**

- *Spontaneous exchange of information*. Information is exchanged spontaneously when one of the contracting parties, having obtained information in the course of administering its own tax laws which it believes will be of interest to one of its treaty partners for tax purposes passes on this information without the latter having asked for it. The effectiveness of this form of exchange of information largely depends on the ability of tax inspectors to identify, in the course of an investigation, information that may be relevant for a foreign tax administration. The competent authority of the contracting party that provides information spontaneously should request feedback from the recipient tax administration as it may result in a tax adjustment for the sending contracting party. For instance, a foreign tax administration informed on a spontaneous basis that commission fees were reported to have been paid to one of its residents, may find out that no commission fees were actually paid and it may report this fact to its counterpart who supplied the information. As a result the deduction of the commission fees will be denied and the taxable income adjusted accordingly.

There are also other forms of exchange of information besides the traditional ones described above:

- *Simultaneous tax examinations*. A simultaneous tax examination is an arrangement by two or more countries to examine simultaneously and independently, each on its territory, the tax affairs of (a) taxpayer(s) in which they have a common or related interest with a view to exchanging any relevant information which they so obtain. The existing differences in statutes of limitations of countries are a major practical consideration in the selection of cases. Such examinations are particularly useful in the area of transfer pricing and in identifying tax evasion schemes involving low tax jurisdictions. The OECD has designed a model agreement for the undertaking of simultaneous tax examinations**.**

- *Visit of authorised representatives of the competent authorities*. Travel to a foreign jurisdiction for purposes of gathering information for a particular case may be useful in certain circumstances. However, this visit has to be authorised by the foreign jurisdiction (and be permitted by the laws of the sending country), otherwise it would represent a breach of sovereignty. Thus, the decisions on whether or not to authorise such visits, and if so, whether the presence of foreign tax officials should require the consent of the taxpayer (as well as any other terms and conditions for such visits) fall within the sole discretion of individual countries. The tax officials must be authorised representatives of the competent authorities. This presence abroad may occur in different instances. It may be at the request of the country seeking information if it is felt it will facilitate the understanding of the request and the gathering of information. It may be at the initiative of the requested competent authority to reduce the cost and burden of gathering information. In a number of countries, authorised representatives of the competent authorities of the other country may participate in a tax examination and this is often of great value to ascertain a clear picture of business and other relations a resident of a country may have with his foreign associates.

- *Industry-wide exchange of information*: An industry-wide exchange of information does not concern a specific taxpayer but an economic sector as a whole, for instance, the

pharmaceutical industry or the oil industry. An industry-wide exchange involves representatives of contracting parties meeting to discuss the way in which a particular economic sector operates, the financing schemes, the way prices are determined, the tax evasion trends identified, etc.

4. The Basic Rules of International Information Exchange.

Exchange of information is mandatory.[1] The obligation to exchange information is not limited to information contained in the tax files held by a tax administration. Where requested information is not available in the tax files, the requested party must use its information gathering measures to seek to obtain the information from the taxpayer(s) or third parties. This may include special investigations or special examination of the business accounts kept by the taxpayer or other persons. Under paragraph 4 of Article 26 of the OECD Model Tax Convention whether or not the requested party has an interest in the information for its own tax purposes is irrelevant. Information must be provided even where the requested party does not need the information for the administration or enforcement of its own tax laws.

The legal obligation to supply information is lifted in a limited number of situations. In connection with the OECD Model Convention these exceptions are contained in paragraphs 3 through 5 of Article 26. In the rare cases where the exceptions apply, the contracting parties are not obligated to provide information. The decision to provide or not to provide the information is then left to the discretion of the requested contracting party. It follows that a competent authority may decide to provide the information even where there is no obligation to do so. For instance, where a request relates to information that may involve a trade secret, a competent authority may still provide such information if it feels that the laws and practices of the requesting State together with the confidentiality obligations imposed under the applicable exchange instrument ensure that the information cannot be used for the unauthorised purposes against which the trade or secrecy rules are intended to protect.

[1] In connection with the OECD Model Convention this is due to the use of the word “shall” in the first sentence of Article 26. In the CIAT Model Agreement the same language is found in Article 4.

Any information received should be treated as confidential.[2] The confidentiality rules apply to all types of information, including both information provided in a request and information transmitted in response to a request. If the secrecy provisions under the domestic laws of a Contracting State are narrower than under the applicable exchange instrument, then the provisions of the exchange instrument will have no consequences. If the domestic rules are broader, however, then the confidentiality provisions will put a restriction on the use of information received from abroad. The local tax authorities are under the obligation to refer to their competent authorities any issue which may arise concerning the disclosure of the information received.

5. The Basic Rules of International Collection Assistance.

Article 27 of the OECD Model Tax Convention provides that a Contracting State is obliged to assist the other State in the collection of taxes of every kind and description, provided that the conditions of the Article are met. At present however, provisions on assistance in tax collection included in bilateral tax conventions generally concern only taxes covered by the tax conventions.

The assistance concerns tax claims i.e. any amount owed in respect of taxes covered by the assistance but only insofar as the imposition of such taxes is not contrary to the Convention or other instrument in force between the Contracting States as well as the interest, administrative penalties and costs of collection or conservancy that are related to such an amount.

The conditions under which a request for assistance in collection can be made are that the revenue claim has to be enforceable under the law of the requesting State and be owed by a person who, at that time, cannot, under the law of that State, prevent its collection. This will be the case where the requesting State has the right, under its internal law, to collect the revenue claim and the person owing the amount has no administrative or judicial rights to prevent such collection. Except with respect to time limits and priority, the requested State is obliged to collect the revenue claim of the requesting State as though it were the requested State's own revenue claim. The requesting State can ask the other State to take measures of conservancy if the revenue claim is

[2] See Article 26 paragraph 2 OECD Model Convention, Article 8 OECD Model Agreement, Article 22 of the Council of Europe/OECD Convention, Article 4 paragraph 9 CIAT Model Agreement.

not yet enforceable or when the taxpayer has a right to prevent its collection. The legal obligation to supply assistance is lifted in a limited number of situations contained in paragraphs 5 of Article 27

6. Recent OECD Initiatives.

There are a number of recent OECD initiatives that have been undertaken in the area of international information exchange and cross-border collection assistance. These include an update of Article 26 of the OECD Model Convention, efforts to improve the practical aspects of information exchange, efforts to improve information exchange with offshore financial centres, and efforts to improve the operation of assistance in tax collection provisions.

Update of Article 26

Provisions modelled on Article 26 of the OECD Model Tax Convention are by far the most frequently used mechanisms for exchanging information. More than 2000 bilateral income tax conventions are based on the OECD Model Tax Convention. Article 26 sets forth the rules under which information may be exchanged between tax authorities.

To ensure the continued relevance of Article 26, the OECD's Committee on Fiscal Affairs recently undertook a comprehensive review of Article 26. This work has now been completed and the Committee adopted in July 2004 a revised Article 26 which is included in the 2005 update of the Model Convention (see Annex 1 for the text of Article 26 and Commentary). The revision brings Article 26 in line with current country practices and incorporates the work the Committee on Fiscal Affairs has undertaken with respect to access to bank information and in developing the 2002 OECD Model Agreement on Exchange of Information in Tax Matters (discussed in more detail below).

With the completion of the work on Article 26, the Committee on Fiscal Affairs has now developed up-to-date mechanisms for exchange of information both as stand alone tax information exchange agreements and in the context of comprehensive income tax conventions. In developing these models the OECD focused on providing different models that fit different situations while ensuring that the key standards of exchange are consistent irrespective of which model is used. There has been considerable input from Non-OECD Economies in this work and 25 Non-OECD countries have already endorsed the revised Article 26.

The key changes to the previous version of Article 26 can be summarised as follows:

Changes to text of the Article:

- The standard of “necessary” has been changed to “forseeably relevant.” Revised Article 26 now provides that Contracting States shall exchange information that is “foreseeably relevant” for carrying out the Convention or for the administration or enforcement of their domestic tax laws. The “foreseeably relevant” standard is also found in the Joint OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters and the 2002 OECD Model Agreement. The Commentary explains that the change was made to achieve consistency across exchange instruments and was not intended to alter the effect of the provision.

- A new paragraph 4 has been added to deal explicitly in the text of the Article with questions of domestic tax interest requirements. A domestic tax interest requirement refers to laws or practices that would prohibit the competent authority of a Contracting State from exchanging information requested by the other Contracting State unless the requested Contracting State had an interest in such information for its own tax purposes. The new paragraph clarifies that Contracting States should obtain and exchange information irrespective of whether they also need the information for their own tax purposes. The same standard was already incorporated in the 2002 OECD Model Agreement and, as described in the 2003 progress report, Improving Access to Bank Information for Tax Purposes, all OECD countries have now addressed the issue (for further information see www.oecd.org/ctp).

- A new paragraph 5 has been added dealing with ownership information and information held by banks, financial institutions, nominees, agents and fiduciaries. New paragraph 5 provides that a Contracting State cannot decline to provide information solely because it is held by such a person or solely because it is ownership information. This is consistent with the practice of the vast majority of OECD countries and reflects the standard also contained in the 2002 Model Agreement. The most important consequence of this change is that domestic bank secrecy rules by themselves can no longer be used as a basis for declining to provide information.

- The confidentiality rules in Article 26 have been changed so as to permit disclosure of information to oversight authorities. This change reflects a growing trend in OECD countries. Oversight authorities are authorities that supervise tax administration and enforcement authorities as part of the general administration of the government of a Contracting State.

Changes to the text of the Commentary:

- Optional language has been included in the Commentary for countries wishing to share information for non-tax purposes (i.e. to counteract money laundering or corruption). It provides that Contracting States may use the information for other purposes provided the information may be used for such purposes under the laws of both countries and the use is authorized by the competent authority of the supplying country.

- Language has been added to clarify a number of terms and concepts used in Article 26. The revised Commentary contains more detailed explanations on (i) the principle of reciprocity, (ii) trade, business and other secrets, (iii) the attorney-client and similar privileges and (iv) the term “public policy/public order.”

Efforts to improve practical aspects of information exchange

The OECD has developed a new “OECD Manual on the Implementation of Exchange of Information Provisions for Tax Purposes.” The purpose of this Manual is to provide tax officials dealing with exchange of information for tax purposes with an overview of the operation of exchange of information provisions and some technical and practical guidance to improve the efficiency of such exchanges.

In designing the Manual the objective has been to be as practical as possible and as global as possible. Non OECD Economies and regional tax organisations were invited to comment on the earlier drafts of the Manual.

The Manual follows a modular approach as some modules may not be relevant to all countries depending on the type of exchange countries are engaged in and as it facilitates updates and additions of new modules. The present modules are the following:

General module: general and legal aspects of exchange of information.

Module 1: Exchange of information on request.
Module 2: Spontaneous exchange of information.
Module 3: Automatic (or routine) exchange of information.
Module 4: Simultaneous tax examinations.
Module 5: Tax examinations abroad.
Module 6: Country profiles regarding information exchange.
Module 7: Information exchange instruments and models.
Module 8: Industry-wide exchange of information.

The OECD Manual is now being used by CIAT as a basis for developing its own manual on exchange which will be tailored to the CIAT model agreement on exchange of information.

In addition to developing the Manual the OECD is also working on improving the technical aspects of exchange of information. An increasing number of countries are engaged in automatic exchange of information. Information suitable for automatic exchange is typically bulk information comprising many individual cases of the same type, usually consisting of details of income arising from sources in the supplying state where such information is available periodically under that state's own system and can be transmitted automatically on a routine basis. Automatic exchange of information requires standardisation of formats to be efficient. The OECD has developed and continues to develop standards for automatic exchange taking into account the latest technological developments. The new format is called the Standard Transmission Format (STF) and is based on extensible mark up language (XML), a document mark up language widely used in today's information technology for its many advantages. The OECD Standards have also been adopted with the necessary amendments by the European Council for the implementation of the EU Savings Directive.

In order to speed up exchange of information on request or spontaneous exchange in appropriate cases, the OECD has also recommended procedures for secure electronic exchange (i.e. the transmission of communications of competent authorities in encrypted files attached to email messages).

Efforts to improve exchange of information with offshore financial centres

One of the significant challenges for governments is the increased scope for illicit use of the financial system, including tax evasion, which has been brought about by an increasingly borderless financial system. In response

to this challenge, the OECD launched in 1996 the harmful tax practices initiative. The work has proceeded on three fronts: 1) identifying and eliminating harmful tax practices of preferential tax regimes in OECD countries, 2) identifying "tax havens" and seeking their commitments to the principles of transparency and effective exchange of information, and 3) encouraging other non-OECD economies to associate themselves with the harmful tax practices work.

The OECD established 4 key criteria for identifying harmful tax practices:

- No or nominal taxes, in the case of tax havens, and no or low taxation, in the case of member country preferential tax regimes.
- Lack of transparency.
- Lack of effective exchange of information.
- No substantial activities, in the case of tax havens, and ring-fencing, in the case of member country preferential regimes.

The no/nominal/low taxes criterion is merely used as a gateway criterion to determine those situations in which an analysis of the other criteria is necessary. The adoption of low or zero tax rates is *never* by itself sufficient to identify a jurisdiction as a tax haven or a preferential tax regime as harmful. The OECD does not prescribe appropriate levels of taxation or dictate the design of any country's tax system.

In 2000, the OECD identified 35 jurisdictions that were found to meet the tax haven criteria[3] and 47 *potentially* harmful preferential tax regimes in OECD countries.[4] A process was also established whereby the identified tax havens could commit to improve transparency and establish effective exchange of information for tax purposes. Those jurisdictions that were not willing to make such commitments would be included in a list of uncooperative tax havens. Thus, the key distinction for OECD countries became whether a tax haven was co-operative or unco-operative.

[3] Six other jurisdictions – Bermuda, Cayman Islands, Cyprus, Malta, Mauritius and San Marino – were not included in the 2000 Report because they committed to eliminate their harmful tax practices prior to the release of that report.

[4] The potentially harmful preferential regimes were classified by category (e.g. insurance, financing and leasing, fund managers, etc.) with some regimes falling within more than one category. Thus, while there are 61 entries in the table of potentially harmful preferential regimes in the 2000 Report, there were only 47 potentially harmful preferential regimes. Note that this paper does not deal further with this aspect of the work. Detailed information is available on the OECD website (www.oecd.org/taxation).

In April 2002, the OECD issued the list of uncooperative tax havens. The list initially had 7 jurisdictions, but two jurisdictions – Nauru and Vanuatu – made commitments in 2003 and the list now contains only 5 jurisdictions: Andorra, Liberia, Liechtenstein, the Marshall Islands and Monaco. The 33 jurisdictions below have agreed to work with OECD members to improve transparency and to establish effective exchange of information.[5]

Anguilla Antigua and Barbuda Aruba Bahamas Bahrain Bermuda Belize British Virgin Islands Cayman Islands	Cook Islands Cyprus Dominica Gibraltar Grenada Guernsey Isle of Man Jersey	Malta Mauritius Montserrat Nauru Netherlands Antilles Niue Panama Samoa	San Marino Seychelles St. Lucia St. Kitts & Nevis St. Vincent Turks & Caicos Islands US Virgin Islands Vanuatu

The jurisdictions referred to above, together with OECD countries, work to develop international standards for transparency and effective exchange of information in tax matters under the auspices of the OECD's Global Forum on Taxation as "Participating Partners." A specially created working group developed the Model Agreement on Exchange of Information on Tax Matters (available at http://www.oecd.org/ctp) which is now being used as the basis for the negotiation of bilateral tax information exchange agreements. Since 2000, the US has signed such agreements with Antigua and Barbuda, Aruba, The Bahamas, the British Virgin Islands, the Cayman Islands, Jersey, Guernsey, Isle of Man and Netherlands Antilles. The Netherlands signed an agreement with the Isle of Man on 7th October 2005, which closely follows the Model Agreement, and Bermuda signed an agreement with Australia in November 2005. Many more agreements are currently under negotiation between OECD and the 33 countries identified above.

[5] Three jurisdictions — Barbados, Maldives, and Tonga — that were identified as tax havens in the 2000 Report are not Participating Partners nor are they listed as Unco-operative Tax Havens. Barbados has been found to have longstanding information exchange arrangements with other countries that were found by its treaty partners to operate in an effective manner. Barbados is willing to enter into tax information exchange arrangements with those OECD countries with which it currently does not have such arrangements. It also has in place established procedures with respect to transparency. In addition, the Committee determined after careful review that the Maldives and Tonga no longer met the tax haven criteria.

The Global Forum has been working towards a level playing field with respect to transparency and effective exchange of information in the tax area. This was discussed at a meeting of the Global Forum in June 2004 in Berlin. The participants agreed on a number of individual, bilateral and collective actions. In connection with the collective actions the participants agreed to carry out a review of the transparency and information exchange practices currently applied by financial centres (including all OECD countries, the 33 Non-OECD Participating Partners and other significant financial centres). The reviews will be summarised in a factual report which demonstrates the degree of convergence on the implementation of the transparency and information exchange standards OECD has set. A draft factual report was presented at a meeting in Melbourne in November 2005 which brought together over 140 delegates representing more than 50 governments. The participants generally endorsed the factual report which is expected to be published in the first half of 2006.[6]

Efforts to improve the operation of assistance in tax collection provisions

The OECD is in the process of developing a Manual on Assistance in Tax Collection. The goal of the Manual is to provide an overview of the operation of assistance in tax collection provisions and some technical and practical guidance to improve the efficiency of such assistance.

B. THE ADMINISTRATION OF TAX DEBT COLLECTION ACTIVITIES

1. Introduction.

Effective use of exchange of information procedures to assist the collection of unpaid debts presupposes that there is a well-established system of organization, management, policies, procedures and systems (including technology) in place that underpins the overall debt collection function. Achieving all of this in practice is by no means a simple

[6] This work has received considerable political support. The G7/8 Finance Ministers have consistently provided political support for the project And G7 Heads of Government confirmed their support at the Gleneagles Summit in Jul 2005. Also, at the November 2004 meeting of the G-20 Finance Ministers a strong statement in support of this work was issued and further endorsement of this work was provided in the most recent G-20 Communiqué issued in October 2005.

undertaking given the many issues to be addressed. But it is highly important. As noted in the CIAT handbook…. "Collection is the main objective of a Tax Administration and the reason for its existence."[7]

The OECD's Committee on Fiscal Affairs (CFA) has only recently commenced to study tax debt collection strategies and practices in member countries. This work resulted from concerns expressed in 2004 by some member countries about the growing incidence of unpaid taxes and a desire to better understand how other countries were carrying out this function and the impacts of their efforts. The CFA's work commenced in 2005 and is being carried out by the Forum on Tax Administration (FTA), a CFA subsidiary body.

To date, this work has entailed a meeting of country experts and a survey of country practices and analysis of responses, the detailed results of which have recently been documented for member countries. While it is not possible to provide CIAT members with detailed country-by-country findings, it is possible to describe the work's broad findings and conclusions which should be of interest to CIAT members. However, before doing so, it is considered helpful to emphasize some general principles and approaches for carrying out tax debt collection work that were applied in designing the FTA's survey of country practices.

2. General Principles and Approaches Applied to Frame the Survey of Country Debt Collection Practices.

There is a body of literature[8] on tax administration pointing to country approaches in the conduct of enforced tax debt collection work. While there is no universally agreed set of formal principles or best practices in this respect, it is possible to draw out some common threads and approaches that can be associated both logically and on the basis of the results achieved in practice with an effective and efficient debt collection function. This experience was used to inform the design of the FTA's survey. These principles and approaches are described briefly hereunder:

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[7] Handbook for Tax Administrations, Organizational Structure & Management of Tax Administrations, CIAT (2000)

[8] Including but not limited to tax administration conference papers, published reports of external auditing bodies, official publications, tax administrations' annual reports and business/ corporate plans, and country reviews by international organizations (e.g. the IMF).

- *Institutional arrangements:* Tax debt collection is an important and integral part of the overall tax administration process and is not a function that can be readily divorced (e.g. outsourced) from mainstream operations.

- *Legislative framework:* The efficiency and effectiveness of a tax administration's enforced debt collection activities depends critically on the adequacy of underlying legal framework in place, including the provision of an appropriate regime of sanctions (e.g., interest and/or penalties) to deter and penalize non-compliance. In practice, this legal framework is set out separately in the laws governing each tax administered or, preferably for ease of legislative maintenance, in a single comprehensive law on tax administration that provides a common set of provisions, including for enforced debt collection, covering all taxes.

- *Organisation and management arrangements:* Tax administrations with effective collection enforcement programs pay close attention to the way this function is organized and resourced. Given the importance of collection enforcement and the specialized skills it involves, many modern tax administrations include a specialised department that is responsible for all activities relating to arrears collection (and the related function of securing overdue tax returns).

- *Performance objectives and measurement:* Enforced debt collection and return filing operations constitute a critical program of work in national tax administrations in all OECD countries, given their direct relationship to the achievement of budget revenue targets and the significant level of resources involved. It thus stands to reason that these operations should be underpinned by sound management practices including the use of a comprehensive set of performance measures/ indicators (that are both output and outcomes-focused) and with close monitoring of the results and quality of operations achieved in practice.

- *Business Processes:* Well-designed administrative procedures are needed to ensure that a tax administration's collection enforcement powers are applied effectively. Indeed, a tax administration's formal statutory powers to collect tax arrears — as set out in the tax legislation — may be of little

practical value in the absence of appropriate administrative procedures to follow up instances of non-payment. Recognising this, mature tax administrations typically employ a systematic approach to the collection enforcement process that comprises a graduated set of collection actions, methodical investigative techniques, and a number of important institutional arrangements. Also critical is the timeliness of actions taken to pursue unpaid debts — there is considerable private sector experience pointing to the timeliness of collection action as a critical factor in the overall rate of revenue collections achieved.

- *Use of information technology:* Perhaps more than any other area in tax administration, collection enforcement is a highly time-sensitive function that requires fast access to accurate information concerning all aspects of a taxpayers' affairs (particularly covering all tax debts and outstanding tax returns) and other information sources (e.g. asset data) that can be utilised to assist enforcement of the law. For this reason, many tax administrations are known to have made considerable efforts in developing computer systems to support their debt collection activities. These systems provide a broad range of tools for both managers and front-line collection enforcement officers.

- *Human resource management (HRM):* The debt collection function typically involves a relatively large number of staff, many of who require a broad range of skills (e.g. taxpayer contact, negotiation, and financial analysis) and competent management. Effective HRM strategies are essential.

Applying these broad principles and approaches, a survey questionnaire was designed and implemented in 2005 for all OECD member countries and South Africa, an observer country to the CFA.

3. 2005 Survey of Debt Collection Practices—Key Findings and Conclusions.

The information set out in this section provides a high level summary of findings and observations, based on survey responses from 26 countries, and conclusions concerning the strategies and approaches

being taken both to encourage improved payment compliance and to deal efficiently with individual cases of non-payment. Where relevant, some country examples are provided to further explain individual approaches. While the survey encompassed a fairly broad range of inquiry, it was not intended to be an exhaustive study of the subject area; rather, the objective was to establish a base level of information as a pointer to potential areas for more in-depth examination as part of future work by the FTA.

Institutional arrangements

- Tax debt collection is typically a core and major responsibility of national tax administrations and with very few exceptions (or variations on a theme) this was confirmed in responses to the survey. By way of exception, the survey identified some institutional arrangements unique to a few Nordic region countries, an outsourced approached in Italy (to be partially reversed in 2006), and an initiative by the US IRS to outsource some of its debt work from 2006.
- Given their basic responsibilities/core competence for collecting revenue, tax administrations are potentially well placed to collect other (non-tax) debts owing to government. The survey revealed this to be the case: 1) 17/26 tax administrations have been tasked with collecting non-tax debts; and 2) such non-tax debts typically include student loans, child support, and overpaid welfare benefits.

Legislative framework

- A number of powers are fairly universal in their availability to tax administrations. These include powers to 1) grant extensions of time to pay; 2) formulate payment arrangements; 3) collect tax debts through specific third parties who owe money to a taxpayer or hold money on their account; 4) offset taxpayers' tax debts against credits arising under other taxes; 5) initiate (or arrange for) seizure action; and 6) initiate bankruptcy/ liquidation action.

- □ther powers reported as less frequently available (and for some requiring a court order), included powers:

- impose restrictions on overseas travel by debtor taxpayers (12/26 countries);
- effect the closure of a business or withdrawal of a business licence (10/26 countries);
- obtain a lien over a taxpayer's assets (19/26 countries);
- withhold non-tax payments owed by government to debtor taxpayers (17/26 countries);
- disqualify debtor taxpayers from bidding for government contracts (16/26 countries);
- impose liability on company directors for certain company tax debts (20/26 countries); and
- require a tax clearance certificate from taxpayers (in some cases, subject to a threshold) who bid for government contracts (20/26 countries).

– With very few exceptions, government do not have any priority over secured creditors for the collection of tax debts.

– A majority (15/26 countries) reported the existence of a statutory period during which enforced collection action must be initiated, although in many cases these periods can be extended under particular circumstances; in the main, these statutory periods were of around 5 years in duration.

– With minor exceptions, virtually all countries provide for the imposition of interest on unpaid/late paid debts; 15 countries operate a uniform regime where interest is applied at a single standard rate across all major taxes, and which is regularly reviewed and kept in alignment with movements in official bank interest rates. Some examples appear below:

Country	Method for setting quantum of sanction
Australia	The interest rate is reviewed quarterly and is the monthly average yield of 90-day Bank Accepted Bills published by the Reserve Bank of Australia plus 7 percentage points. For the quarter ended 30 June 2005 the rate was 12.63% per annum. The interest is cumulative and is calculated daily on the outstanding debt.
Czech Rep.	For each day of default the penalty shall be in the amount of 140% of the Czech National Bank discount interest rate which was effective on the first day of the appropriate calendar quarter.
Finland	The penalty interest or surtax is the reference interest rate of the six-month period preceding the current calendar year, plus seven (7) percentage points. In the year 2005, the interest rate is 9.5%.
Japan	The rate of the delinquency tax is higher than that of the commercial rate and is set in two phases according to the delinquency period. In general, it is 14.6%/per year, but for the 2 months from the due date, the rate is normally 7.3%/per year. The Special Taxation Measure Law also determines the reduction of the rate based on the discount rate. In 2005, a special annual rate (4.1%) is applied for the two month period after the due date.

- For 17/26 countries, the law provides separate penalty sanctions (often varying by tax type), while 9/26 countries provide a single sanction (reflecting both 'interest' and 'penalty' elements).

- 3 countries provided details of special incentive arrangements, including reduced rates of interest or penalty, that are designed to encourage the payment of debts without resort to further enforcement action (see further details hereunder).

Country	Description of special incentive arrangement
Australia (ATO)	*Small Business Debt Assistance Initiative:* Under this initiative a reduced interest rate was offered together with flexible payment options on outstanding tax owed by eligible small businesses as at 30 June 2004. Taxpayers were required to provide the Commissioner with the authority to directly debit instalments from their bank account and meet future filing and payment obligations. Taxpayers who failed to take up the offer faced legal action through the courts or the issue of garnishee notices on bank accounts. Taxpayers were advised that this was a one-off opportunity for eligible businesses to pay their debts on favourable terms or face firm action by us. Offers were sent directly to eligible taxpayers, with a response required within 28 days of receiving the offer. The initial response from the community has been very positive, with many people contacting the ATO before a letter was sent. An on-going strategy is to allow small business taxpayers to pay arrears of tax by instalments at the reduced interest rate of 10% per annum.
Canada (CRA)	The CRA is currently conducting a pilot project on graduated penalties for late remittance of source deductions. Our existing 10% late penalty structure has been modified to 3% for 3 days, 5% for between 3 and 5 days, 7% for 5 to 7 days and 10% thereafter.
New Zealand (IRD)	Where a payment arrangement is entered into before the due date the initial penalty is reduced. This has the effect of encouraging taxpayers to contact the IRD before the tax becomes overdue. For instalment arrangements entered into after the due date, penalties are suppressed while the terms of the arrangement are kept, although use of money interest accrues throughout. Penalties are suspended in the following situations: 1) where agreement has been reached to pay debt by way of instalment arrangements; 2) where taxes have been remitted due to inability to pay (e.g. hardship, uneconomic to pursue); and 3) written application by taxpayer for remission in relation to one off circumstances.

– All countries responded that they are generally empowered to waive/write off (or have referred for write off action) debts

that are deemed irrecoverable, although in some cases there are time limits and drawn-out procedural steps involved; most tax administrations are generally empowered to re-raise such debts if there are changes in the circumstances of the taxpayers concerned.

- Around two thirds of countries reported that their double tax treaties and/or the EU Directive on Mutual Assistance in Tax Matters provide for assistance concerning the collection of tax debts; Norway reported the most extensive range of agreements—bilateral agreements with some 19 countries and two multilateral agreements: The 1989 Nordic Convention on Mutual Administrative Assistance in Tax Matters and The 1988 OECD/CoE Convention on Mutual Administrative Assistance in Tax Matters.

- To indicate the extent of reliance on such agreements, one country (i.e., Germany) provided the following statistical data for 2004 for debt recovery-related matters—around 850 requests pursuant to the EU Directive and some 550 requests pursuant to various double tax agreements.

Organization and management arrangements

- Just over half (14/26 countries) reported the establishment of a centrally organised/dedicated function to direct and deliver tax debt collection and related functions.

- 9/26 tax administrations reported data related to the staffing resources used for tax debt collection (and related functions); where available, the quantum of this data confirmed the significance of this function in overall administration terms—7/9 tax administrations indicated that staff resource investments were at least equivalent to 10 percent or more of total agency staffing.

Performance objectives and measurement

- The survey identified substantial variations in the nature and scope of performance targets and measures applied to managing tax debt collection and return filing, suggesting this could be a valuable area for future work.

– The most frequently cited 'outcomes' focussed measures/ indicators were: 1) the percentage of returns filed and/or tax paid by the legislated due date or by some other prescribed date (see example below); and 2) the ratio of year-end tax arrears to net (or gross) annual tax collections.

Tax type	Average of tax collected in due month (%)	
	2003	2004
PAYE	93	93
VAT	85	84
Income (non PAYE)	97	95
Capital gains	98	94
Corporation	90	81

Tax type/ case size	VAT and PAYE return compliance in due month (%)	
	2003	2004
PAYE: Large	91	92
PAYE: Medium	85	86
VAT: Large	88	88
VAT: Medium	78	78

Source: 2004 Annual Report (Irish Revenue)

– The most frequently cited 'output' measures were: 1) number and value of cases finalised; 2) number and value of new cases intake; and 3) cash collections on debt cases.

– A number of countries formalise their expected performance in corporate/business plans or by way of official government agreements that are linked to agency funding/resource agreements. Some examples of formalized performance objectives/ indicators are set out below:

Country	Expected results	Indicators	Targets
Canada (CRA)	Tax debt is resolved on a timely basis and is within targeted levels	Dollar amount of cash collected	$8.6 billion in 2005-06
		Percentage of accounts receivable > 5 years old	2005-06—less than 16%
		Accounts resolved compared to new accounts intake	More than 91% of accounts resolved in 2005-06
		% of intake resolved in the year of intake	60-65% of accounts resolved in 2005-06
France (DGI)	Responding to non-compliance with filing and payment obligations	% of businesses that fail to file to file their annual business return on time	2003—2.1%; 2004—2.0%; and 2005—<2.0%
		Net rate of recovery proceedings in non-payment cases	2003—53.5%; 2004—54.0%; and 2005—54.5%
	Reinforcing and promoting taxpayer compliance	Rate of timely compliance with VAT filing obligations	2003—83.0%; 2004—84.0%; and 2005—86.0%
		Rate of voluntary compliance with individual filing obligations	2003—97.5%; 2004—97.6%; and 2005—97.8%
		Rate of timely payment of business taxes	2003—98.0%; 2004—98.0%; and 2005—98.0%

Sources: Canada—Summary of the Corporate Business Plan (2005-2008); France—Performance Contract (2003-05)

– Around half of surveyed countries were unable to report comprehensively on the status of collection activity concerning all outstanding debt (e.g., the amount of debt subject to collection arrangements, bankruptcy action, or dispute) of the debts within their overall inventory.

Business processes

– Taxpayer education has an important role to play, including the use of public outreach events to encourage compliance with laws. One country example is set out below:

Country	Description of Public outreach activities to promote compliance with tax laws
Canada	***Community Volunteer Income Tax Program (CVITP***): under this program, volunteers working with various organizations across Canada donate their time and effort to assist eligible individuals with simple tax situ ations to prepare their income tax and benefit returns***.*** During the 2004 – 2005 fiscal year, over 5,000 volun teers helped approximately 455,026 Canadians prepare their income tax and benefit returns. ***Teaching Taxes***: The Teaching Taxes Program introduces high school and post-secondary students to Canada's tax system and the importance of tax revenues within the Canadian society. It also teaches students how to prepare a basic income tax and benefit return. In 2004 – 2005, we distributed 5,290 teachers' manuals and 97,040 student workbooks. ***Small Business Information Seminars (SBIS):*** The CRA offers in-depth seminars about payroll requirements, Income Tax and the GST/HST, and often partners with provincial or other federal government organizations to deliver joint educational sessions to business clients. These seminars are for newly registered small and medium business clients. The number of Small Business Information Seminars given in 2004 – 2005 was approximately 1,460 with approximately 21,368 participants.

– Virtually all countries reported the adoption of a graduated set of actions to remind taxpayers of unpaid taxes and to seek payment of the amounts involved; however, there were significant variations reported in the timeframes involved and the nature of actions taken at critical points of the enforced collections process; size of debt is an important criterion in assessing priority for collection action in many countries.

- Tax administrations are starting to use automated risk criteria to identify cases for advanced enforced collection action; further work is needed to assess the benefits of these risk profiling approaches.

- 11/26 of tax administrations reported the use of dedicated call centre operations to assist with tax debt and filing delinquency cases; in the tax administrations concerned, the call centres appeared to play an important role in dealing with taxpayers on tax debt and non-filing related issues.

- 20/26 countries identified phone action as the most predominant method for bringing cases to finalisation; the other important actions identified were instalment arrangements and the use of attachment orders/ garnishees of monies from third parties.

- Most countries (20/26 countries) reported that their debt collection officials typically have a degree of authority to formulate payment arrangements with those taxpayers who cannot fully meet their payment obligations; 10/26 countries reported that instalment arrangements are more or less automatically granted to smaller debtors provided they can complete the arrangement within a prescribed relatively short timeframe.

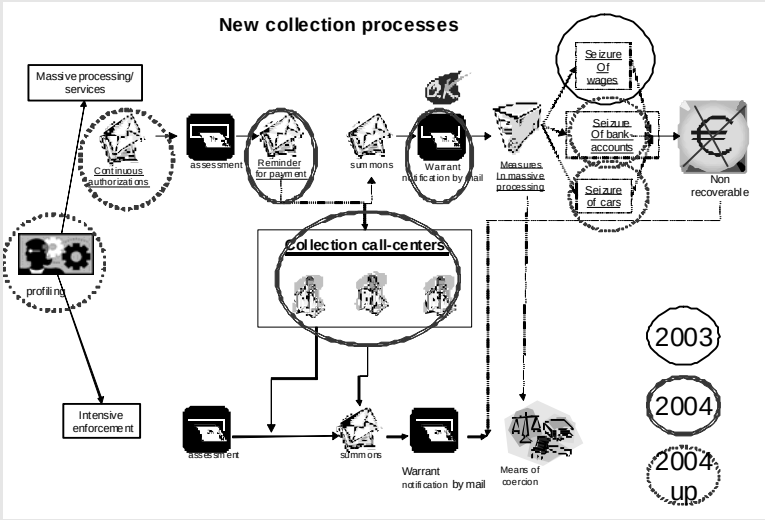
- While country data in the area of granting instalment arrangements was not complete, there appears to be considerable variation across countries as to the administrative priority to be given to striking arrangements to pay with taxpayers who cannot meet their payment obligations in full.

- Major recent initiatives identified to encourage payment compliance were 1) significant emphasis to the availability of electronic payment capabilities (especially direct debiting); 2) expansion of automated call centre arrangements for debt pursuance; and 3) major revamping of organizational arrangements and business processes.

- One country (i.e. The Netherlands) reported that it is carrying out a fundamental reform of its collections processes. Key elements of their reform strategy are described in Box 1.

Box 1. The Netherlands: Modernising Tax Debt Collection

- A new approach was developed which included the following elements: 1) development of a new business strategy, values, and goals; 2) new modernized and simplified processes; 3) an emphasis on quick wins (i.e. within 3 month chunks) to improve business performance over the short term; 4) development of a business case to predict future performance with the modernized arrangements; 5) use of a flexible and experienced project team; 5) going to market to find packaged solutions rather than building in-house.
- A process architecture for the new modernized processes (expected to be fully implemented in 2007) has been completed and gives strong emphasis to centralization of large scale payment processing work, improved risk profiling, integrated debtor administration, automation of case management elements and improved management information; management information;



- Recognising the timeframe involved with the full redevelopment effort, the project team developed a range of short/medium term 'quick win' initiatives, consistent with the longer terms strategy and goals;
  The range of quick wins included a system of payment reminders (01/2005), implementation of collection call centres (01/2005), sending warrants by mail (01/2004), seizure of taxes from wages (10/2003), and seizure of bank accounts and cars (2005).

Source: Netherlands Tax and Customs Administration (IOTA, June 2004)

In its 2004 annual report, the administration reported a substantial reduction in the absolute and relative amount of tax outstanding and noted that this had been a by-product of more efficient use of writs of execution. From 2004, writs were able to be served by post (speeding up the process by some 6-8 weeks) with the aid of an automated process which enabled a very substantial increase in the number of writs served (up from 975,000 (2003) to 1.6 million (2004)).

– While data on the use of third party garnishees/attachment orders (e.g. to employers, financial institutions) to enforce collection was not sought as part of the survey, data from other sources (mainly annual performance and/or statistical reports) suggest that there are enormous variations across countries in the extent of usage of this tool to enforce debt collection.

– The most frequently cited external information sources that are used to facilitate debt collection were (in priority order): 1) banks; 2) real property register; 3) vehicles register; and 4) employers

Use of information technology

– Only 3 of 26 countries reported that they had the full range of capabilities described for survey purposes (see below) in their existing IT systems to support their debt collection work, while another 12 indicated the great majority of these capabilities were in place.

Capability	**Definition**
Single 'whole of taxpayer' view in taxpayer accounting system	The ability to readily ascertain a complete picture of a taxpayer's liabilities (and related information) across all types of taxes.
Automated issue of reminders etc	Computer-generated correspondence to taxpayers at pre-determined milestones
Automated identification of 'high- risk' cases for priority action	The application of in-built 'risk rating' criteria in order to identify at risk taxpayers in a timely manner

Fully automated case management capabilities (as described in survey)	Typically include automated new case identification and allocation, monitoring, correspondence generation, case closure and management information
Automated form generation	Automated generation of prerequisite forms (e.g. legal documents)
Automated imposition of interest and penalties	Periodic automatic updating of taxpayers' accounts with accrued interest and/or penalties which may be notified to taxpayers by way of updated statements of account

- In terms of capability gaps, the key areas identified from the survey responses were 1) the absence of a single 'whole of taxpayer' view of all debts (12 countries); 2) an inability to identify by automated means 'high risk' cases for priority attention (17 countries); and 3) lack of the full range of automated case management capabilities (14 countries).

- The extent of automated access to third party databases (i.e., real property, motor vehicles, company share ownership, corporate registrations, and bank account ownership data) also varies significantly across countries:

  - only 3/26 countries reported access to the full range of databases of external information;
  - 17/26 countries reported access to 3 or more of the sources indicated; and
  - the least accessible data sources were company share registers and bank account ownership detail.

- 12/26 countries provide on-line access to taxpayers' accounts information to taxpayers and their tax representatives.

Human resource management issues

- The majority of tax administrations place emphasis on the development of specialist skills in negotiation, financial analysis and tax and civil law and provide formal training in these areas.

- The bulk of staff tend to be recruited from other parts of the tax administration or directly via civil service processes; only a minority of countries place emphasis/give priority to the employment of university-qualified staff for enforced debt collection work.

- Around half of surveyed tax administrations have formalised team or individual-based performance/ productivity measurement processes.

- 5/26 tax administrations reported the use of formal quality assurance processes to gauge the quality of work outputs. One example is described briefly hereunder.

Country	Description provided of quality assurance process
Australia (ATO)	***Team Based Quality Assurance*** is an inter nal quality assurance process conducted each month at team level. The review methodology provides an assurance that the decision relating to the collection of debt was supported by the available facts, the facts were sufficient to enable a good decision to be made and the decision was in accordance with ATO policy and practice. ***Work Type Quality Assurance*** is conducted quarterly, unless identified for monthly review due to the level of risk in the decisions being made. The process uses a statistically random sample of 97 cases of decisions made within the specific work type (e.g. Arrangement Management, Correspondence or Income Tax Filing). The cases are reviewed by an independent team of Technical Advisors. ***Technical Quality Assurance*** is a corporately assurance program conducted twice each year. Decisions are randomly selected and reviewed by a panel. The panel includes senior technical officers and a qualified external professional. The external representative is generally from a small to medium sized accounting firm with experience in representing taxpayers in relation to debt and filing obligations.

– 2 tax administrations reported the existence of pay bonus schemes to reward staff for good performance, while a larger but not significant number of administrations reported the existence of agency-wide remuneration bonus arrangements.

Overall debt collection performance

– Measured in terms of the relative size of debt inventories, case inventories, and amounts of tax written off, the overall performance of, and levels of payment compliance achieved by, national tax administrations in surveyed countries varies enormously and warrants further examination to more clearly identify contributing factors.

4. SUMMARY

The CFA's initial work has confirmed the importance of the tax debt collection function but identified that there are many potential areas for improvement across surveyed countries. More in-depth examination is required in a number of areas and this matter will be given further attention as part of the CFA's program of work and in line with country interest and commitment.

The work further reinforces the importance of exchanging knowledge and experiences to learn from each others' practices and demonstrates the willingness of tax administrations to do so. The choice made by CIAT to select the topic of debt collection for the 2006 General Assembly is thus timely and well chosen.

Case study

TOPIC 3.1

INTERNATIONAL ADMINISTRATIVE COOPERATION

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CONTENTS: 1. Introduction.- 2. Tax Information Exchange.- 2.1. Functions and Legal Instruments.- 2.2. Information Exchange Efforts: Types and Implementation. Setbacks..- 3. Mutual Assistance in Recovery.- 3.1. Functions and Legal Instruments.- 3.2. Types and Implementation.- 4. Administrative Cooperation in Portugal.- 4.1. Legal Instruments Warranting Cooperation.- 4.2. Responsible Entities.- 4.3. Quantitative Data.

1. INTRODUCTION

International tax oversight plays a relevant role in the effectiveness of tax systems, whether in terms of design of a number of their regulations, or the operational nature thereof, which is a function of Tax Administrations.

Tax planning in new businesses within a global economy– multinational corporations-, frequently operating in a framework of harmful tax competition, originating from countries or jurisdictions with zero or low taxation policies, have become a current feature. In fact, in the present, broad powers exist to relocate businesses and decide according to the most economically beneficial tax regulations in place. Based on policies

that have been purposely designed to attract investment according to the different specific statuses and with a view to offsetting difficulties in their economies, whether structural or purely cyclical. And one of the offspring of this pursuit of economic benefits is, undoubtedly, the tax component. Businesses avail themselves of maneuvers, sophisticated to a greater or lesser extent, to locate their tax bases in zero or low taxation countries or jurisdictions (sometimes only symbolic benefits), which have gained increasing importance, qualitatively as well as quantitatively. That is the basis for tax asset erosion in the countries referred to, in a complex mesh of harmful tax competition, with a distortion of business flows and the impact on resource allocation on a global basis.

The attitudes assumed by the States, worldwide, as to the adoption, in their domestic legal system, of measures to counter these practices that are more equitable in order to face this phenomenon, have not rendered the expected outcomes. Experience tells that only in the context of joint and close efforts it will be possible to achieve effective actions enforceable in the struggle against said practices. Bilateral or multilateral cooperation efforts among countries, in other words, mutual administrative assistance, which essentially include exchange of information and assistance in collection of tax claims, have been the focus of all the parties concerned about this issue, be them national tax authorities, international tax organizations or revenue agencies, institutions or otherwise.

2. TAX INFORMATION EXCHANGE

2.1. Functions and Legal Instruments.

It is not exaggerated to assert that in current Tax Administrations, gathering, treating and using the information required in the assessment and collection of tax liabilities from each taxpayer is an essential function.

Internationally, exchange of information is a vital requirement to endow Tax Administrations with the means to counter the practices undertaken by taxpayers who operate in foreign countries, in the sense of ensuring compliance with all tax obligations applicable, and especially, tax payments.

In terms of direct taxation, based on the principle of the overall or global base revenue, which is the element that translates into economic capacity or tax-payment capacity, knowledge as to the revenue generated externally becomes a vital condition for enforcement and pursuit of justice and fairness in the tax system.

The exchange of information, as the pillar for appropriate payment of tax revenue, has long been an imperative need. Proof of this is the wording of the first and subsequent versions of the OECD Model Convention, which have always provided for a specific regulation to embody the information exchange mechanism. Originally, it was meant to serve the interests defined in the Convention, and thereafter, especially from the 1977 Model, it granted the power to exchange information with a view to securing proper enforcement of domestic tax legislation (income taxes) of the Contracting States. The 2003 version broadens the scope even further to include all domestic taxes, of whatever nature.

Notwithstanding, and as mentioned above, the issue exceeded the functionality linked to the appropriate enforcement of conventions and/or domestic legislation. With globalization, relocation, virtualization and absence of intermediaries in the business world that is the basis and ground for taxation, tax asset erosion came to worse, stemming from effective tax fraud phenomena sometimes and others from pure tax avoidance or, plainly by procuring the less onerous tax deal. The truth is that problems are greater today. Earning the assets required to sustain a reasonable Welfare State, with which we have become used to coexisting, sets forth a dilemma in this context: either the existing tax model is radically modified or it survives, with mandatory use of instruments that ensure the current model and the necessary capacity to meet the demands of the assets entailed.

Said instruments are, obviously, those that demand and enhance the enforcement of actions to secure a high level of international tax cooperation.

The OECD, based on the conventional model, and moreover on the efforts to counter harmful tax practices, sustaining the current tax system and the underlying legal-constitutional principles thereof, produced in 1998 a specific report,[1] which was effective until the report dated March 25th.[2] The European Union (EU) approved, in turn, the "Code of Conduct"[3] as a political commitment.

This same concern existed at the dawn of the Council of Europe/OECD Convention in 1988, a multilateral convention that sets forth information exchange obligations among Tax Administrations of the Signatory States, with a similar scope –since it is not identical – to the Conventions on double taxation.

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1 "Harmful Tax Competition – An emerging issue", January 1st, 1998.
2 "The 2004 Progress Report: The OECD's Project on Harmful Tax Practices".
3 COM (97) 546 Final Version, December 1st, 1997.

In line with these efforts and actions, the European Union became concerned with the issue of exchange of information. Upon approval of Directive 77/799/EC of 19 December, notwithstanding the amendments thereto,[4] always focused on enhancing and making such a fundamental mechanism of mutual administrative assistance and cooperation more operational.

More recently, the European Union has laid the groundwork for survival of the tax model that applies to return on savings in the State of residence of the respective beneficiary on the exchange of information. Applying the mechanism of source withholding on return on investment arising from savings investment (essentially interest), paid in a Member State to individuals resident in another Member State, the latter was chosen based on the use of the information exchange mechanism as the preferred instrument and enforce taxation of said returns in the actual State of residence of the beneficiary (Directive 2003-48-EC of 3 June 2003). In fact, by the mandatory automatic exchange of information provision between the source State and the State of residence, States obtain the indispensable information required to enforce taxation on said returns.

As known, only three European Union Member States remain outside this system– Austria, Belgium and Luxembourg. These States, for a limited time, shall be allowed to continue with the source country taxation system.

Additionally, and upon enactment of the new Directive, to enhance the efficacy of the discipline set forth by the directive, agreements were held with third party countries and related jurisdictions.

This calls for a reference to the information exchange mechanism as the guarantor of the VAT regime (transitory) after removal of physical and tax barriers among the States of the European Union. Then, in 1992, the VIES was enforced as the basis for the system operation. Later, and with the challenges posed by the emergence of E-commerce, the modification embodied in Regulation Nº 792/2002 of 7 May 2002, became the instrument to ensure enforcement of current regulations to the new type of transactions. More recently, the need to make improvements to secure the continuance of said transitory regime, considering the tax fraud and evasion mechanisms brought about by the removal of border controls (of which “carrousel fraud” is a clear example), the approval of an enhanced and more detailed mechanism for administrative cooperation and information exchange was

[4] Directive 79/1070/EC of 6 December 1979; Directive 92/12/EC of 25 February 1992; Directive 2033/93/EC of 7 October 2003 and Directive 2004/56/EC of 21 April 2004.

required, with Regulation Nº 1798/2003 of 7 October 2003. Presently, the extension of the mechanism is being considered, which affected trade in goods to date, to services, provided that the supply rules entail the adoption of reverse charges.[5]

Likewise, a current trend is to execute international bilateral agreements that provide for specific mechanisms to exchange information, – the Tax Information Exchange Agreements, to guarantee access to relevant information with countries that are not bound by the discipline of the EU Directives and with which there are no Double Taxation Conventions (DTC) subscribed or in effect, in order to streamline the process in case of EU Member States or contracting States signatory to the DTC. Upon implementing this, the OECD released the OECD Agreement on Exchange of Information on Tax Matters on 18 April 2002.

2.2 Information Exchange Efforts: Types and Implementation. Setbacks.

Notwithstanding, the provisions in the OECD Model Convention on Information Exchange (Article 26) solely state that "The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention of any nature and kind…", in the respective comments (refer to Nº 9), three individual forms of information exchange have been accepted: on request, automatic and spontaneous. Nevertheless, the three forms may be combined, without exhausting all the methods available to said purpose. States may even resort to other techniques to gather useful information. One example worth mentioning is the implementation of simultaneous tax examinations in foreign jurisdictions and exchange of information relative to a business sector overall.

Additionally, EU Council Directive 77/799/EC of 19 December, approves said forms for all taxes save Value Added Tax; the latter is covered by the system defined in EC Regulation Nº1798/2003, and moreover, the Council of Europe/OECD Convention of 1988.

The materialization of all and any of these forms of exchange of information, from the theoretical as well as operational aspects, the latter being the

[5] In this regard, mention is being made to a "VIES II", which, nevertheless, is to be implemented in 2008.

most relevant for Tax Administrations, require overcoming significant hurdles to grant enhanced value and attention to the State Administrations' approach towards tax information exchange in the performance of their functions. Along those lines, we find undefined concepts, inaccurate formulas, deficient articulation of discipline, and above all, lack of awareness. All this impairs functionality and efficacy in the information exchange mechanism.

Nevertheless, and in spite of the setbacks, great progress has been achieved. Information flows were increased and improved, requests for specific audits were processed, and regulations were put in place for visits from foreign officials and simultaneous examinations.

Upon acknowledging that it is easier to conduct automatic exchange of information already held by Administrations based on taxpayers' compliance with tax obligations respectively, the digital storage of that information was provided for and the frequency of automatic exchanges (structured or otherwise) defined, acknowledging that in this context, the experience that stems from automatic exchange efforts as required by the recently issued Directive 2003/48 of 3 June (on Taxation of Savings) shall enable a faster and better progress, harmonizing the specific features that still prevail and are detrimental to the operational power of procedures. But it must be highlighted that this new directive was a great step towards tearing down the barriers on continuous personal data exchange pursuant to Directive 95/46/EEC of 24 October 1995. Specific provisions were introduced to offset said limitations following the significant step taken previously with VAT Regulation Nº 1798/2003 of 7 October 2003, in case of fraud or grounded suspicions of fraud.

On the other hand, and in order to ensure the needs and requirements of the legal instruments that discipline administrative cooperation in general and information exchange in particular, by acknowledging that it is indispensable that tax officials have a deep knowledge of Community Law, essential actions were implemented through the Fiscalis program –created by European Parliament and of the Council Decision Nº 888/98/EC of 30 March 1998 – to provide support to information exchange efforts in the framework of mutual assistance in order to improve the desirable cooperation among Member-States and guaranteeing the enhanced enforcement of existing regulations, which are, undoubtedly, vital instruments for the issue under analysis, and that is the basis for this reference. Nevertheless, these are not legal instruments that govern tax information exchange.

The outcomes attained were the basis for Decision Nº 2235/2002/EC of the European Parliament and of the Council of 3 December 2002, which approved the Program for an additional five-year term.

Among the Program's activities we find those in line with communications and information exchange mechanisms, multilateral examinations with the participation of Member States and other eligible countries that have entered into bilateral or multilateral agreements, seminars, exchanges and education programs.

Exchanges were performed under the scope of the Program between General Revenue Agency officials with officials from Tax Administrations of other States, which contributed to improve reciprocal knowledge of respective tax systems and their proceedings, gathered from effective work performed.

The program is open to participation of other related countries from Central and Eastern Europe, pursuant to the conditions set forth in European agreements.

3. MUTUAL ASSISTANCE IN RECOVERY

3.1. Functions and Legal Instruments.

In the framework of administrative cooperation, the trend regarding mutual assistance in recovery efforts has shown less significant progress than exchange of information. While the latter, as mentioned above, was introduced from the onset by the OECD Model Convention in 1963, the former has been included in this instrument only since 2003, nevertheless, before that date, some countries introduced regulations in this regard in the Double Taxation Conventions they entered into, to a greater extent after the Council of Europe/OECD Convention of 1988.

There are reasons to warrant the fact that countries accepted the information exchange regulations more willingly in the bilateral DTCs they subscribed, which as far as recovery assistance matters consider the unique nature thereof. Information exchange essentially pursues cooperation among States in the sense of the appropriate enforcement of their tax regulations with a view to determining the assessment of the amounts due, while recovery assistance pursues subsequent cooperation efforts by the contracting States with the goal of enforcing, in general terms, measures

to achieve enforced collection of debts. Therefore, this task requires a vital compatibility among the structures of tax systems of the Contracting States in this regard, as a sine qua non condition to attain effective operational capacity in their efforts, which is not always the case. Increasingly, States fear that the introduction of this kind of provisions in international treaties may bring about detrimental effects in the efforts to attract investment, preferring the alternative of defining domestic management and collection measures that ensure recovery without resorting to ever complex mechanisms that this type of cooperation undoubtedly calls for.

Notwithstanding, the fact that the OECD Model Convention has introduced Article 27 in the 2003 version, specifically dealing with mutual assistance in recovery, a fact that is one of the most relevant changes in said model, in line with the awareness in countries as to this being an additional means to counter tax evasion with positive implications as far as asset collection is concerned, foresees a trend by which respective inclusion shall be assumed a vital issue for signatory States.

Also in the European Union, awareness increased as to the relevance of the issue for a better operation of the European Market, by the approval of Directive 76/308/EC of 15 March 1976, which, owing to a number of modifications thereto[6], has been broadening its scope of action to almost all tax claims, whether stemming from the tax systems of different Member States or those closely linked to their own resources.

3.2. Types and Implementation.

In the context of Double Taxation Conventions, the enforcement of proceedings relative to recovery assistance depends, first and foremost, of the will of the Contracting States as to the inclusion or not in the treaty of a provision for said purpose. In that case, it sets forth the enforcement parameters desired, in other words, it enables to select a more restricted clause or a broader clause, should the implementation of the respective measures be left for the future, or to the contrary, should the decision be for immediate enforcement of the mechanisms to be observed by the parties in the tax liability collection procedure, to the broadest extent possible.

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[6] Directive 79/1071/EC, 6 December 1979, Directive 2001/44/EC, 15 June 2001, supplemented by other Directives that determine the necessary practical modalities to enforce Directive 76/308/EC.

The issue is different in terms of Directive 76/308/EC 15 March 1976 and the Directives that amended it subsequently, by virtue of the mandatory nature of the respective overlapping for the legal systems of the different Member States, defining for them the full reciprocity of rights and obligations, as to Applicant States and Requested States.

As to the mutual assistance for recovery, it is usual to identify, among the information measures, notification measures, precautionary remedies and tax liability enforced collection actions.

The information measures are related to information gathering and transmission among the Applicant and Requested States, considered relevant for collection of tax liabilities. Notification measures are essentially geared at facilitating voluntary compliance in the Requested State by taxpayers who, for any reason, as of the date the tax amount becomes due, reside or are based in the Requested State. The latter, upon request of the Applicant State, shall undertake the necessary actions to notify the taxpayer of the debt.

The last two modalities, based on precautionary remedies and enforced collection of the tax debt assume, in this context, the essential features of the topic under discussion, visibly and remarkably impact the personal status of taxpayers. The purpose of the request for precautionary remedies is to ensure that the Applicant State may secure payment of tax claims with assets or entitlements owned by the taxpayer in the Requested State, with a view to the effective payment of the debt.

As to effective enforced collection actions, the purpose thereof is that the tax claim of the Applicant State be matched with a tax claim of the Requested State in the latter's jurisdiction, aimed at pursuing the coercive proceedings provided in their domestic legislation, to guarantee payment of the tax liability.

Given the fact that these two last types of measures significantly impact the situation of taxpayers on the one hand and on the other, the resources allocated by the Requested State to meet the claims of the Applicant State, certain limitations apply in the implementation of these measures by the latter. Relative to precautionary remedies, the Applicant State may only appeal for enforcement thereof if their domestic legislation and that of the Requested State foresees it. As to the enforced collection measures, a legal requirement applies to verify a number of previously agreed conditions among the contracting States, as to the respective enforcement thereof, which broadly refer to the conditions foreseen in Nº 8 of said Article 27 of the OECD Model Convention.

4. ADMINISTRATIVE COOPERATION IN PORTUGAL

4.1. Legal Instruments Warranting Cooperation.

To this point, we have especially highlighted the OECD Model Tax Convention on Income and Capital and the EC Directives, on the grounds they are the benchmark documents for Portuguese legislation in this regard.

As to information exchange, and under the OECD framework, the early steps date back to 1968[7], with several international conventions (DTC) subscribed since then with a number of countries.[8]

All of them, except for the DTC executed with Switzerland,[9] provide for information exchange measures, needless to say, with specificities among them pursuant to the will of the contracting States.

In the framework of the EU, and in spite of Portugal's accession in 1986, there was a transitory period in which only in 1989 it was deemed mandatory to include Directive 77/799/EC of 19 December 1977 in the domestic legislation, as it stemmed from Executive Order Nº 127/90 of 17 April. In the subsequent amendments thereto, the Decree also underwent amendments.[10]

In this context, since it unequivocally translates the will of the State to intensify information exchange efforts and other forms of cooperation and mutual assistance, the execution of a Bilateral Agreement between Portugal and the Spain has been of the utmost importance, moreover since both are bordering countries.

As to the other form of administrative cooperation, relating to recovery assistance, the tradition has been, in the framework of the DTCs

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7 Convention between the United Kingdom and Northern Ireland – Executive Order Nº 48497 of 24 July 1968.

8 45 DTCs have been executed to date.

9 Executive Order Nº 716/74 of 12 December.

10 Executive Order Nº 52/93 of February 26, Act Nº 39-B/94 of 27 December, Executive Order Nº 235/96 of 7 December, Act Nº 87/B/98 of 31 December and Act Nºº 55-B/2004 of 30 December.

executed to date, not to include any provision in this regard, except for the DTCs between the Netherlands and Portugal[11] and Portugal with India.[12]

In the framework of the European Union, Portugal introduced the guidelines set forth by Directive 76/308/EC of 15 March 1976 in their domestic legislation, in the framework of adapting to their future accession based on Executive Order Nº 504-N/85 of 30 December, as amended thereafter[13] by the sequence of amendments in said Directive 76/308/EC. Finally, and once the text of this Directive was consolidated, Executive Order Nº 296/2003 of 21 November currently stands for the global instrument of discipline for mutual assistance in recovery efforts.

4.2. Responsible Entities.

The entity responsible for administrative assistance, except for that relative to recovery assistance in the framework of the UE, has been until very recently the Fiscal Benefits' Services Direction, through a sector that has been specially selected for this purpose.

Nevertheless, aware of the increasingly relevant role of international relations in this regard, Portuguese tax authorities have included in the organizational structure of the General Revenue Agency, the International Relations' Services Office. Its creation was set forth by Executive Order Nº 257/2005 of 16 March, and it defines a set of functions that materialize the above-mentioned aspects in terms of administrative assistance, originating in the tasks that are attributed thereby, highlighting, among others, those relative to:

- ensuring information exchange in coordination with the tax examination area under the framework of the instruments foreseen in international conventions in fiscal matters and Community Law;

- participating in the articulation with the tax examination area, in international cooperation actions under the scope of tax evasion and fraud prevention;

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11 Resolution Nº 4/99 of 28 January of Parliament.
12 Resolution Nº 20/2000 of March 6 of Parliament
13 Executive Order Nº 186/89 of June 3 and Executive Order Nº 69/94 of 3 March.

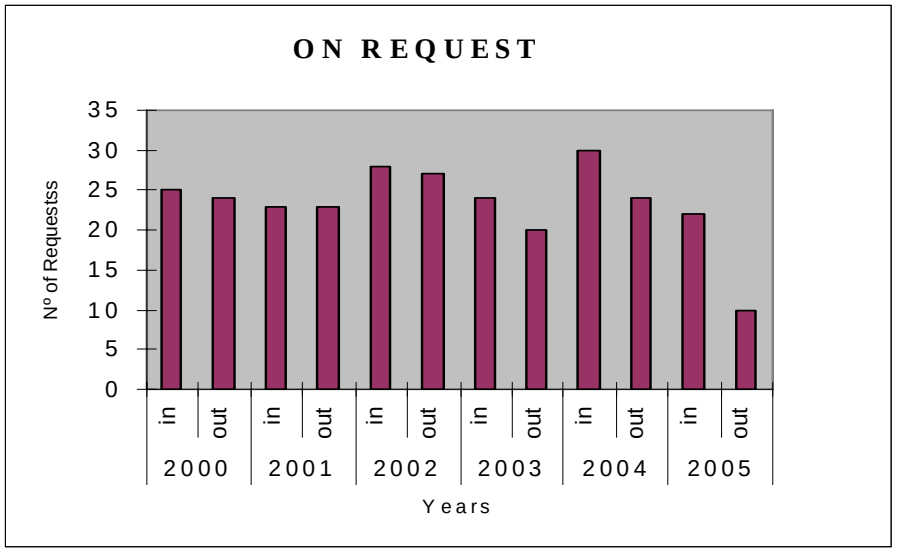
- participating in actions under the framework of the European Union, or the OECD and other international agencies, including the national delegations in the different committees and working groups within said agencies in the area of administrative cooperation and mutual assistance.

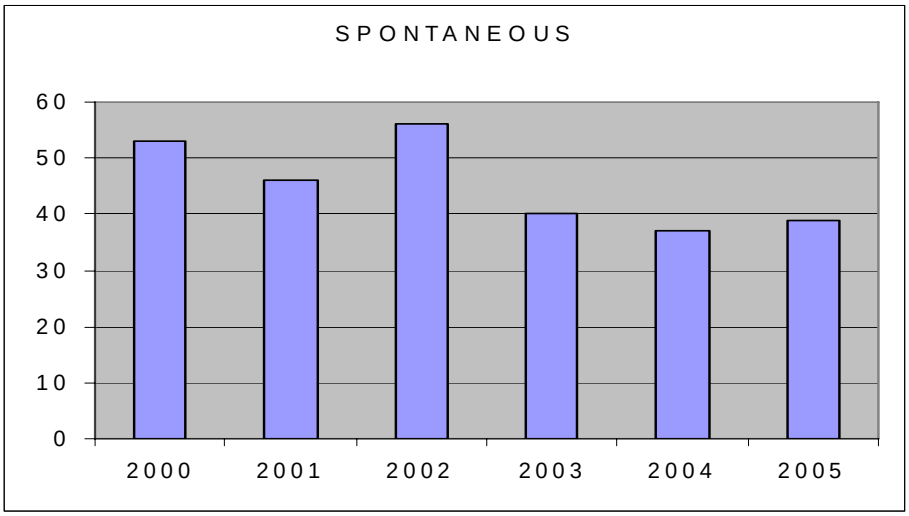
As to recovery assistance, the responsible agency, with the status of an Interministry Committee was created by Executive Order Nº 160/2004 of 14 February. Representatives from a number of ministries participated in said committee given the need to cooperate based on the different components of the phenomenon.

4.3. Quantitative Data.

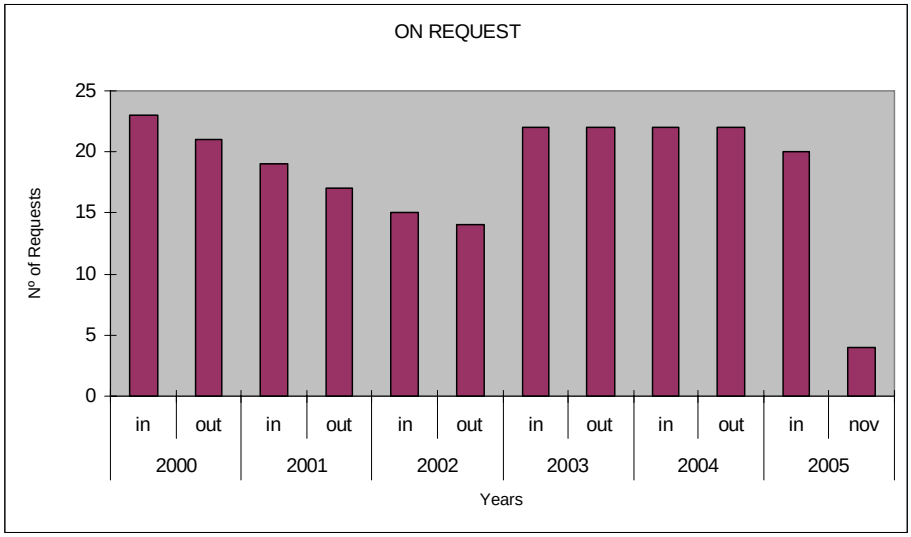
4.3.1. Information Exchange

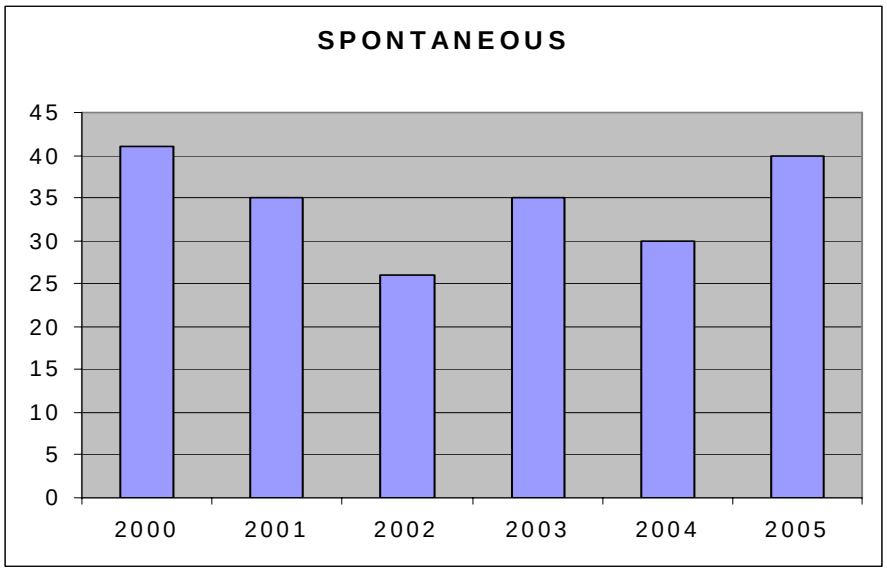
4.3.1.1. Requests Received and Reported and Spontaneous Information Forwarded.





4.3.1.2. Requests Made and Reported and Spontaneous Information Received.





The analysis of the charts relative to exchange of information on request, even with slight fluctuations, evidences a reasonable consistency during the period under study, whether in number of requests received from other States or in number of requests forwarded by Portugal to other States. We may therefore draw the conclusion that the level of answers delivered and received is satisfactory in the relations with other contracting States as to the exchange of information on request proceedings, as well as the number of processes incoming and completed (in and out).

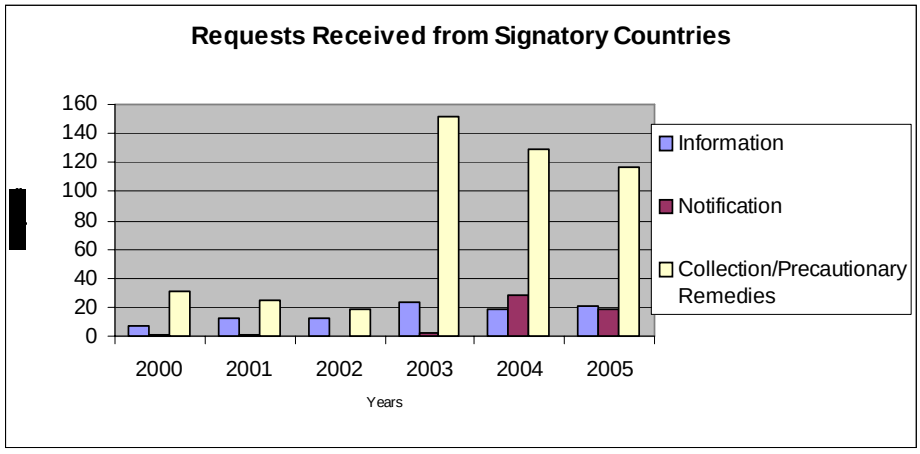
Normally, information exchange on request is related to the processes which call for the participation of other units, such as the designation of the Tax Examination Services, and since the number of processes involved is small, Tax Administrations are forced to find the respective answers.

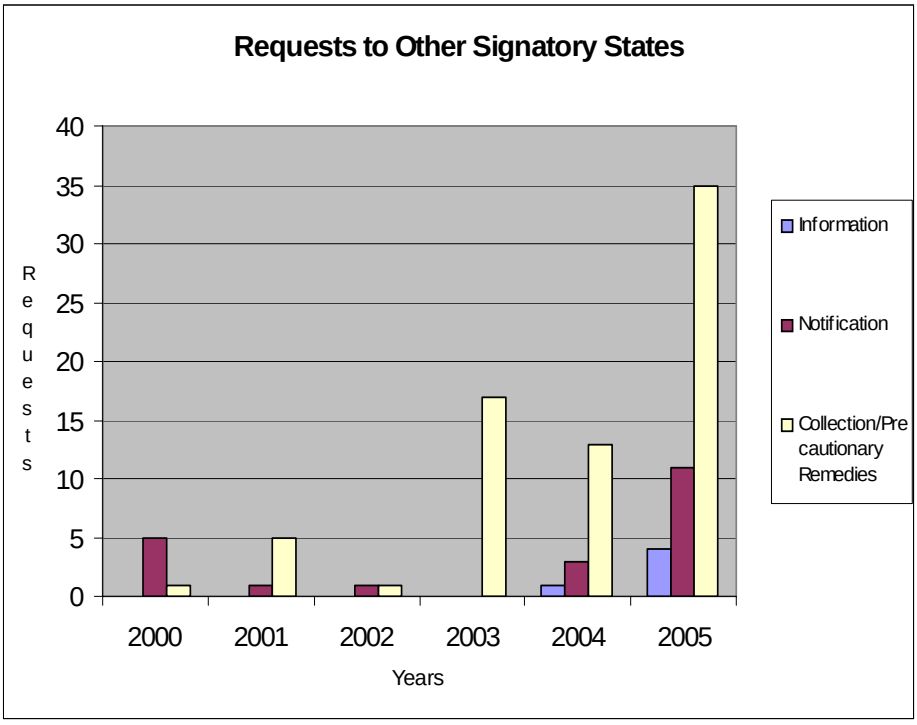
According to existing data, this type of information exchange occurs, in general terms, with countries where there are taxpayers based in certain States and who own equity interests in Portugal and vice versa. It is therefore not surprising that the largest number of requests made and received come from France, Germany, United Kingdom and Spain.

As to spontaneous information exchange, there are no significant quantitative fluctuations during the period under analysis, whether in the information delivered or received. What essentially differentiates this type of information from the previous one is the fact that in the largest number

of cases a process may contain thousands of records, and even relate to a broader set of countries, since in addition to the aforementioned, we must mention Norway, USA and Canada with significant weight.

4.3.2. Recovery Assistance





The charts relative to collection assistance confirm the aforementioned comments, that they are measures normally linked to the enforced collection of tax liabilities of a relevant role, and that information exchange and notifications feature an almost immaterial value.

Another significant aspect, undoubtedly of the utmost relevance, is the marked increase as of 2003 of requests received as well as requests made for collection of tax liabilities. Said evolution is based on the assistance in collection efforts in the European Union that have included other tax claims other than those initially foreseen in Directive 76/308/EC of 15 March 1976, in other words, they have included tax claims related to income tax and capital gains tax.

The information gathered in 2005, also evidences that collection assistance was very focused in a small number of countries. In fact, out of the requests made to other Member-States, only the Belgium and Spain represent over 90% of the overall number, while the requests received from other signatory States, 10% account for Belgium, 60% to the Germany, 15% to Spain, 11% to France and, finally, 3.5% to the United Kingdom. This entails that the mutual assistance measures for collection with the other Member States have not been accounted for to the present.

Case study

TOPIC 3.2

COUNTERING HARMFUL TAX PRACTICES: JOINT EFFORTS AND UNILATERAL MEASURES

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CONTENTS: 1. Fraud and International Tax Evasion and the Use of Low Taxation Regimes.- 1.1. The new approach to harmful tax competition.- 1.2. The code of conduct on business taxation.- 1.3. The OECD report on harmful tax competition practices.- 1.4. The unilateral anti-abuse measures.- 2. Most Relevant Harmful Tax Competition Control Measures Adopted by Portugal.- 2.1. Corrections for special cases.- 2.2. Corrections on transfer pricing.- 2.3. The undercapitalization rules.- 2.4. Non-acceptable costs.- 2.5. Taxation of capital gains or losses.- 2.6. Elimination of double taxation on distributed earnings.- 2.7. Independent tax rates.- 2.8. Tax rates for the municipal tax on real estate.- 2.9. Tax rates for the municipal tax on transfer of real estate for a valuable consideration.- 2.10. Definition of "clearly more favorable tax regime".- 2.11. The general anti-abuse provision.- 2.12. Access to information and bank records.- 3. Case Studies as to the Enforcement in Portugal of Joint and Unilateral Measures to Control Harmful Tax Competition.- 3.1. The case of the regime in the Madeira free trade zone.- 3.2. Enforcement of the general anti-abuse provision.- 4. Conclusions.

SYNOPSIS

This paper shall address the issue of "Countering Harmful Tax Competition: Joint Efforts and Unilateral Measures" with a view to analyzing, on a general basis, the approach to this issue at the level of the European Union and the Organization for Economic Cooperation and Development.

We shall specifically refer to the most relevant unilateral measures adopted by Portugal to counter harmful tax competition, concretely, those that were devised to avoid the abuse of the so-called "clearly more favorable" tax regimes.

We shall conclude with the analysis of two cases: the modifications in the tax system of the Madeira Free Trade Zone based on the sustained efforts in the EU and the OECD and a recent case study from the Portuguese Tax Administration, which exemplifies the enforcement of the general anti-abuse provision set forth in the Portuguese legislation; this paved the way for the creation of a new anti-abuse provision in the Tax Code on Corporate Income, as a reaction to the issue of the abuse of preferential tax regimes.

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1. FRAUD AND INTERNATIONAL TAX EVASION AND THE USE OF LOW TAXATION REGIMES

1.1 The New Approach to Harmful Tax Competition.

In an increasingly globalized world, international fraud and tax evasion[2] tend to intensify, calling for the urgent adoption of measures to effectively control or counter these phenomena. The use of tax havens or preferential tax regimes is, precisely, one of the typical expressions of international tax fraud and evasion, which puts the issue of controlling harmful tax competition in the limelight on a worldwide basis.

Tax competition stems from the natural diversity of tax systems to the detriment of tax advantages, since the features of national tax regimes are based on historic options, intrinsically linked to reasons of political, economic, cultural and social nature of government administrations and citizens. Not withstanding, tax competition is bicephalous. With unquestionable positive effects,[3] it may operate in a predatory manner, unfairly benefiting from the erosion of tax revenue for certain States or territories to the advantage of others.[4]

Beginning in the ‘80s, a generalized trend appeared that introduced preferential or privileged tax regimes, essentially regarding the creation of financial centers, holdings, coordination centers, services centers, reinsurance centers, etc.[5] The dissemination of this type of regimes translated into a response from countries to a growing integration as well as the absence of coordination.

Now, should in a static situation the differences between tax systems go unnoticed, to the extent the globalization process continues, they shall become increasingly relevant and cause harmful effects. To this end, we may refer to a genuine renewed dimension of a problem that has been pervasive regarding tax control policies: tax fraud and evasion.[6]

In this context during the ‘90s we attested, mostly at the level of the European Union (EU)[7] and the Organization for Economic Cooperation and Development (OECD),[8] to an effort to counter or control the detrimental effects of harmful tax competition.[9] [10] Since it is not a new phenomenon, we may assert that, beginning in this decade, a new approach as to tax competition was adopted internationally, with the inevitable domestic consequences in a number of countries.

1.2 The Code of Conduct on Business Taxation.

Among the new instruments that arose in the ‘90s in the European Union, we may highlight the famous Code of Conduct on Business Taxation[11], a commitment of a political nature, a sort of soft law that does not directly impact the legal rights and duties of the Member States.

The Code of Conduct is exclusively applied in the area of direct taxation, specifically on corporate taxation. Therefore, it excludes the scope of indirect corporate taxation and taxation of natural persons, with a vague reference to the area of parafiscal charges.

Regarding direct taxation of corporations, the purpose is to counter detrimental tax measures, including laws, regulations and practices of an administrative nature that imply or may imply a sensitive incidence on the venue for economic activities within a community, equally including in the concept of economic activities all the activities conducted within a same group of companies.

In the provisions of Item B of the Code of Conduct, the measures that foresee an effective tax rate that is significantly lower than the one normally

applied in the respective Member State, including zero tax rate, are to be deemed potentially harmful,[12] since that tax rate may render the nominal tax rate, the revenue amounts or any other pertinent factor. The Code sets forth, only as an example, the assessment of the harm caused by measures and a provision for exclusion of harmful measures (Items B and G). Pursuant to the provisions therein, the Member States shall rollback harmful measures and bring them to a standstill.

For the purpose of enforcing the principles in the Code, a group was set up in 1998 called the Group on the Code of Conduct on Business Taxation or the Primarolo Group[13], which has completed a large number of papers, the most relevant and widely disseminated being the "Primarolo Report" that defines 66 measures "considered harmful".[14]

1.3 The OECD Report on Harmful Tax Competition Practices.

In turn, the OECD Tax Affairs Committee also launched its project in the framework of harmful tax competition, with the approval on 9 April, 1998, of the Report on Harmful Tax Competition Practices. [15]

The Report is a much more elaborated document than the Code of Conduct on Business Taxation and includes a number of considerations on the beneficial aspects of tax competition; nevertheless, it reaches the conclusion that in certain situations, it may be harmful and generate undesirable situations of erosion of national tax bases.

In this context, and estimating the need to control harmful tax competition practices in designated tax havens and preferential tax regimes of member countries,[16] it addresses the applicable identification factors and includes a set of guidelines and nineteen recommendations that shall be abided by Member Countries and, to the extent possible, presented to non-member Countries.

The Report is divided into three chapters that approach, respectively, the effect of the globalization phenomenon with regards to tax systems, the identification factors for tax havens and preferential tax regimes and the recommendations approved to counter them. The Report embodies the rule of the three R's: countries must remove, review and restrict preferential tax regimes.

As regards tax havens, the Report foresees the development of a list to meet said purpose, as well as enforcing strict and appropriate counter-

measures, with a view to operating as a source of deterrence for the creation of new tax havens.[17] In this context, recommendations already provide for a number of applicable sanctions, such as, for example, the application by Member Countries of the Conventions subscribed with said jurisdictions, even considering the possibility of restricting deductions of payments made to entities based in tax havens, the relevance of specific rules on transfer pricing and undercapitalization, and the enforcement of quasi-fiscal charges. It shall be noted that the array of counter-measures or defensive measures applicable to tax havens included on the list have been an issue analyzed in the OECD, and the understanding was reached that they should be enforced on a coordinated basis. Moreover, the modalities of defensive measures to be adopted have been analyzed, as evidenced in the first progress report of the papers delivered in June, 2000. [18]

In order to apply the ongoing principles of the Report, the Forum on Harmful Tax Competition Practices was created in 1998.

1.4 The Unilateral Anti-abuse Measures.

Just as defined in Item K of the Code of Conduct on Business Taxation, *"the anti-abuse provisions or counter-measures included in the fiscal legislation and conventions relative to double taxation play a vital role in the efforts to counter tax evasion and fraud."*

The Special Anti-Abuse Rules, contrary to the General Anti-Abuse Rules, pursue the cases of tax evasion and not tax avoidance (or, as put by certain theory on legal evasion, abusive tax savings, tax planning as opposed to illegal evasion, different from flagrant violations of the law).[19] In broad terms, we may state that for both cases, the figures are below the actual transactions performed, for example, not simulated, conducted with the essential purpose of eliminating or reducing the tax burden ("tax planning"), with the additional distinction that the Special Anti-Abuse Rules pursue specific situations, and operate on a more stringent basis, while the general anti-abuse conditions seek to span an array of situations in which tax law is avoided. [20]

The anti-abuse measures applied to the different countries, pursue the following:[21]

a) To make taxation extensive to situations that, in spite of adopting a different legal entity, lead to the same economic outcome of the tax regulation (theory of the equivalent economic outcome);

b) To tax the core of the tax events, regardless of the legal entities adopted (conditions that make the underlying reality prevail under the entity);
c) Prevent the abuse of applicable legislation (the conditions for abuse of the law in force);
d) Not to attribute commercial relevance to the practices with the sole objective of tax purposes (theory of the business purpose).

If required, the introduction of anti-abuse measures shall be conducted so as not to jeopardize taxpayers' guarantees, that is to say, without detriment to the constitutional principles as it stems from the principle of tax legality.

2. MOST RELEVANT HARMFUL TAX COMPETITION CONTROL MEASURES ADOPTED BY PORTUGAL

It was mostly as of the '90s, owing to the strong influence of community tax harmonization in Portugal, that tax legislation progressively adopted anti-abuse defensive measures to counter international tax evasion and fraud.[22] Thus, measures were phased in into the spectra of income tax and equity tax, tax benefits and stamp taxes, targeted at transactions with entities located in countries, territories or regions qualified as "tax havens" or subject to "preferential tax regimes". We found measures of this type, as applicable, in Nº3 of Article 16º of the Tax Code on the Income of Natural Persons (CIRS, as per the Portuguese acronym), in Nº2 and Nº3 of Article 59º and in paragraph c) of Nº7 in Article 60º of the Tax Code on Corporate Income (CIRC, as per the Portuguese acronym), in paragraph b) in Nº2 of Article 26º, in Nº7 of Article 41º and in Nº 8 in Article 42º of the Articles on Tax Benefits (EBF, as per the Portuguese acronym), in paragraph e), in Nº1 and Nº3 of Article 7º of the Code on Stamp Taxes, in Article 5º of Act Nº 193/2005 of 7 November,[23] in paragraph b) of Nº 4 in Article 2º and in Nº 3 of Article 4º of Act Nº 219/2001, of 4 August[24] , in Nº 7 of Article 9º and Nº 3 of Article 112º of the Code of Municipal Real Estate Taxes (CIMI, as per the Portuguese acronym) and Nº 4 of Article 17º of the Code of Municipal Taxes on Real Estate Transactions (CIMT, as per the Portuguese acronym)[25] .

We shall focus on the most relevant specific anti-abuse measures in Portuguese legislation, taking into consideration the transactions referred to and concluding with a reference to the general permanent anti-abuse provision of the General Tax Act (LGT, as per the Portuguese acronym).

2.1 Corrections for Special Cases.

By means of Act Nº 37/95 of 14 February[26] , a number of anti-abuse measures were created to counter international tax fraud and evasion with the purpose of restricting the use of tax havens or preferential tax regimes, mostly by resorting to corporations domiciled therein.[27]

Current Articles 59º and 60º in the CIRC (formerly Articles 57º-A and 57º-B), respectively, determine the inversion of the burden of the proof when a Portuguese corporation must face charges relative to debts or payments to entities domiciled in said countries or territories, and the compliance with regulations that enable tax payments in the State of residence on the revenue earned by the Headquarters based in tax havens or jurisdictions with preferential tax regimes, which belong to resident shareholders, even if earnings have not been distributed, with the resulting fiscal transparency of these corporations (CFC Rules, Subpart F Rules).[28]

Thus, the conditions defined in Nº1 of Article 59º of the CIRC set forth that "The amounts paid or due to natural persons or corporations resident outside of the Portuguese territory and subject to a clearly more favorable tax regime, of any nature, are not deductible for the purpose of defining the taxable income, except in the case the taxpayer proves that said charges account for effectively completed transactions and are not extraordinary in nature or exaggerated in amount". [29]

To that end, legislation sets forth that an entity is considered to be subject to a clearly more favorable tax regime when:

a) The territory of residence thereof is listed and approved by the Finance Ministry; or
b) When it is not affected by income tax similar or identical to the Individual Income Tax (IRS, as per the Portuguese acronym) or the Corporate Income Tax (IRC, as per the Portuguese acronym); or
c) When, regarding the aforementioned amounts paid or due, the tax amount paid is equal to or lower than 60% of the tax that would be deemed payable if said entity were resident in Portuguese territory.

For the purpose of the above-mentioned, taxpayers shall carry and submit upon request of the General Revenue Service (DGCI, as per the Portuguese acronym), the records that account for compliance with the tax payment by the non-resident entity and the calculations performed for the revenue amount payable should the entity otherwise reside in Portuguese territory, in the cases in which the territory of residence thereof is not included on the list accepted by the Finance Ministry.

It is the role of the Tax Administration, based on the evidence submitted by the taxpayer, to assess and decide whether the transaction was proven to be legitimate or not, whether it was conducted in regular terms and if the amounts thereof are exaggerated or not.

In turn, Article 60º of the CIRC sets forth that "The earnings obtained by non-resident corporations and subject to a clearly more favorable tax regime therein, are allocated to the shareholders domiciled in Portuguese territory, on a pro rata basis to their share of equity ownership and regardless of the distribution thereof, provided that said shareholders own, either directly or indirectly, equity for at least 25%, or in the case of a non-resident corporation, that resident shareholders own either directly or indirectly, more than 50% thereof and account for equity ownership interests of at least 10%." [30]

The allocation is based on the calculation of the tax base for the fiscal year corresponding to the non-resident corporation's tax period that amounts to the revenue earnings thereof, after income tax on earnings, as applicable pursuant to the tax regime in the corporation's State of residence.

For this purpose, it is deemed that a corporation is subject to a clearly more favorable tax regime upon verifying any of the three aforementioned conditions.

2.2 Corrections on Transfer Pricing.

With the tax reform of 1989, which was fundamentally aimed at approving the new tax models for individuals and corporations and equity, came the approval of the Tax Code on Income Tax as well as Corporate Tax, as well as the Autonomous Tax Code, which introduced the anti-abuse rule that is currently part of Article 58 of the CIRC (formerly Article 57º). This provision, quite incipient in its original format, provided for the arm's length price rule, pursuant to the OECD Transfer Pricing Guidelines, enabling the correction on taxation practices in the case of special relations between the taxpayer and other entities in different conditions than those that would be normally accepted among independent entities.[31]

2.3 The Undercapitalization Rules.

Pursuant to the rules defined in Nº1 of Article 61º of the CIRC, in the case of excessive indebtedness of a taxpayer with non-resident entities subject to special relations[32] , the excessive interests borne by the party are deemed

non-deductible from taxable income.[33] To this end, the maximum indebtedness limit applies to twice the value of the share in equity ownership; nevertheless, this ratio may be higher in the cases in which the taxpayer presents valid reasons in that context.

2.4 Non-Acceptable Costs.

As defined in Nº1 of Article 23.º of the CIRC, the costs or losses in a fiscal year shall not be deemed acceptable when they stem from the transfer of capital stock for valuable consideration, of whatever nature, when it was owned by the transferring party for a period of less than three years and when the capital stock was purchased from entities domiciled in the country, territory or area with a clearly more favorable tax regime, as listed and approved by the Finance Minister or the entities that reside in Portugal subject to a special taxation regime.

Likewise, the costs or losses in the fiscal year shall not be deemed acceptable, pursuant to Nº7 in said Article, when they stem from the transfer of capital stock for valuable consideration, whatever the nature thereof, to the entities subject to special relations, as provided for in Nº4 of Article 58º, or to the entities domiciled in the country, territory or area with a clearly more favorable tax regime, as listed and approved by the Finance Minister or the entities that reside in Portugal subject to a special taxation regime.

2.5 Taxation of Capital Gains or Losses.

As defined in Article 45º of the CIRC, the positive difference between capital gains or losses achieved by the transfer of capital stock for valuable consideration, including the redemption and amortization of shares with equity drawdown, shall not be subject to tax by 50%. Notwithstanding, it has been expressly foreseen that transfers and purchases of capital stock for valuable consideration may not be performed with entities that reside in the country, territory or area with a clearly more favorable tax regime, as listed and approved by the Finance Minister.

2.6 Elimination of Double Taxation on Distributed Earnings.

Article 46º of the CIRC, sets forth a double taxation on the distributed earnings regime following the EC Parent-Subsidiary Directive.[34]

In general terms, this regime defines that the income included in the tax base for distributed earnings is deducted from the assessment of taxable earnings of business associations or corporations, or cooperatives and corporations listed on the stock exchange, effectively domiciled in Portuguese territory.

In 2004[35], with the purpose of restricting the abuse of this regime, a new numeral 10 was added to the aforementioned regulation, which sets forth that the regime does not apply, and in such case the additional tax assessments are deemed pertinent, when evidence exists to prove abuse of regulations in order to reduce, eliminate or delay tax payments, which is verified when distributed earnings were not subject to effective taxation or when they originated from income not governed by this regime.

This item was added with the purpose of enforcing an anti-abuse rule for situations similar to that described in 3.2 hereunder.

2.7 Independent Tax Rates.

As set forth in article 81 of the CIRC, independent tax rates shall apply, respectively for 35% or 55% of the expenses from imports paid or owed, of any nature, for natural persons or corporations resident outside of Portugal and subjected to a clearly more favorable tax regime therein, unless the taxpayer proves that said surcharge accounts for effectively conducted transactions and are not deemed extraordinary or of an exaggerated amount.

2.8 Tax Rates for the Municipal Tax on Real Estate.

As defined in Nº3 of Article 112º of the Code of Municipal Real Estate Taxes (CIMI, as per the Portuguese acronym), in the case of buildings owned by entities with tax domiciles registered in the country, territory or region subject to a clearly more favorable tax regime, as listed and approved by the Finance Minister, the tax rate shall be calculated at 5% (regular rates are 0.8% for rural real estate, 0.4% to 0.8% for urban real estate and, for urban real estate assessed according to the provisions in the CIMI, from 0.2% to 0.5%).

2.9 Tax Rates for the Municipal Tax on Transfer of Real Estate for a Valuable Consideration.

The IMT tax rate is always 15% with no exemption or reduction applied, provided that the purchaser resides or is headquartered in the country, territory or region subject to a clearly more favorable tax regime, as listed and approved by the Finance Minister (in regular situations, the maximum tax rate applicable is 6%).

2.10 Definition of "Clearly more Favorable Tax Regime."

The enforcement of anti-abuse measures as foreseen in Portuguese legislation appears because of a complex fundamental problem of a dual nature: the definition of countries or territories to which they apply.

Just as noted in the Ruding Report[36] , the main problem is essentially linked to the fact that the concept of tax haven is an essentially relative concept, since any State would be capable, relative to the other one, of performing under said conditions by simply not taxing certain income or that the tax rates enforced therein be significantly lower. From the analysis of comparing legal systems, the conclusion was drawn that three types of solutions were available: a definition in comparative terms of countries and territories that could be considered tax havens, a conclusive definition and a list on a case by case basis ("blacklists").

Another complex issue consists of the distinction between tax havens and preferential tax regimes. On that basis, Portugal decided to apply anti-abuse measures to situations where "clearly more favorable tax regimes" existed. Additionally, as noted in the preamble of Act Nº 150/2004 of 21 January, which "approves the list of countries, territories and regions with clearly more favorable preferential tax regimes"; "Considering the extent of the difficulties in defining "tax haven" or "clearly more favorable tax regime", our legislation, following the trends of other legal-fiscal regulations, decided for certain cases and in order to secure legal certainty, on the case by case list and, in others, a combined system, bearing in mind that such solutions call for periodical reviews by countries, territories or regions as listed."

According to this Law, there are currently 83 countries, territories and regions featuring clearly more favorable preferential tax regimes.

2.11 The General Anti-Abuse Provision.

Given the impossibility of legally providing for all avoidance behaviors, Portugal introduced a general anti-abuse provision for the first time in the Procedural Tax Code in 1999; subsequently, this rule was included in the General Tax Act in 2000.[37]

The adoption of a general anti-abuse provision in the Portuguese legal and fiscal system was not free from criticism. On the contrary, it was and still is the cause of heated arguments, essentially based on the broad provisions therein and the constitutional principle of the Rule of Law and Typology.[38]

Article 38º Nº1 of the General Tax Act defines and embodies the principle that the inefficacy of legal transactions does not hurdle taxation, when it shall occur legally, in case the economic effects argued by the parties have already come about.

Item Nº2 in this regulation sets forth that, "The legal acts or transactions essentially or mainly targeted at fraud and abuse of regulations are deemed ineffective in the tax sphere, as well as the reduction, elimination or delay in the tax liability payment stemming from events, acts or transactions of a legal nature and with identical economic purpose, or in order to obtain tax advantages that would otherwise not be achieved, either totally or partially without the use thereof; taxation thus enforced according to the applicable regulations in absence thereof and the tax advantages referred to were never enjoyed. "[39]

Therefore, this provision is limited to the cases in which the "corporation solely or mainly pursues tax avoidance purposes, not subjected to oversight when the grounds for the events or contracts were proven to be of a nature other than tax, even when this originates revenue reductions which the Treasury would have otherwise collected."[40] In other terms, pursuant to this provision and considering other systems,[41] efforts have been undertaken to annul the fiscal effects stemming from agreements with the sole or main purpose of avoiding, eliminating or reducing certain tax surcharge.

Therefore, in order to identify a behavior that qualifies for the enforcement of this provision, the following must occur:

a) To resort to an extraordinary legal entity, based on fraud and abuse of legal provisions;

b) To obtain the same economic benefit that would be otherwise obtained if the regular legal entity were used, as provided by tax law;

c) That the extraordinary legal entity is used with the sole or main purpose of eliminating or reducing the tax amount or achieving tax advantages.

The burden of the proof from the assumptions to enforce the general anti-abuse provision is the obligation of the Tax Administration. On the other hand, it is worth highlighting that Article 63º of the Tax Procedural and Process Code foresees a specific procedure for the enforcement of the anti-abuse rules; considered such by the conditions in Nº2 respectively, "any legal rule that embodies the inefficacy with the Tax Administration of businesses or legal acts executed or conducted with clear abuse of legal provisions that result in the elimination or reduction of taxes that would be otherwise payable." Thus, as foreseen in Nº 7 and 8 of said regulation, the enforcement of the general anti-abuse provision depends on the approval of the top tax authority and does not apply when the taxpayer previously requested information from the Tax Administration as to the underlying events and the latter failed to answer within a term not exceeding six months.

2.12 Access to Information and Bank Records.

The Portuguese legislation relative to the access to information and bank records has been updated in time. In the early days, it only provided for indirect access to these data via a court order, as from 1999, it allows for direct access by the Tax Administration, and the scope has been expanded since then.

Therefore, Article 63º B of the General Tax Act determines that the Tax Administration has the power to directly access bank records, in cases in which taxpayers in preferential tax regimes refuse to disclose them or authorize access thereto.[42]

3. CASE STUDIES AS TO THE ENFORCEMENT IN PORTUGAL OF JOINT AND UNILATERAL MEASURES TO CONTROL HARMFUL TAX COMPETITION

3.1 The Case of the Regime in the Madeira Free Trade Zone.

The case of the Madeira Free Trade Zone (ZFM, as per the Portuguese acronym) or the International Business Center of Madeira (CINM, as per the Portuguese acronym) is a paradigmatic example of the enforcement of joint control measures on harmful tax competition.[43]

The CINM regime was conceived as a program integrated by tax incentives, considering the development of an ultraperipheric region with strong structural issues, based on a long-term strategy. This is a preferential tax regime and not a tax haven, subject to the same general rules on control and oversight from official entities and information exchange rules in force in the rest of Portugal.[44]

This regime is deemed as State assistance in the guise of tax assistance with regional development objectives for which it requires approval by the European Commission.[45] Under these conditions, the respective compatibility with the common market was subsequently analyzed and confirmed by the Commission, with the regime's approval for the first time in 1987, for a three-year period; in 1991, for a three-year period again; in 1994, for a six-year period, in the same conditions as the first approval; and in 2002 and 2003, for a four-year period. Pursuant to the first three authorizations by the Commission, tax assistance could be granted to companies authorized by the CINM, mostly in the form of total exemption from Corporate Income Tax until the end of 2011. This regime essentially entails the provisions in Article 33º of the Tax Benefit Law, which governs four business sectors: the Industrial Free Trade Zone, International Services, International Ship Registry and Financial Services.

Notwithstanding, this regime was changed, among other factors, owing to continuous work in the community group on the Code of Conduct on Business Taxation[46] and the OECD Forum on Harmful Tax Competition Practices.

In fact, in both cases, the works were based essentially on taxation of variable activities, mostly financial activities, and the financial activities of the CINM were qualified as harmful CINM.[47]

Therefore, pursuant to the latest decisions by the Commission, the new CINM regime in effect as of 1 January, 2003 was authorized for a four-year period, equally effective until 31 December, 2011, for entities Approved on 1 January 2003 to 31 December 2006, in the business sector within the Industrial Free Trade Zone, International Services, and the International Ship Registry, excluding financial services and financial intermediaries and the intragroup services' activities (coordination centers, treasury and distribution). This regime is based on Article 34º of the Tax Benefits' Law, distinct from the first regime if we consider the benefits granted (introduction of minimum Corporate Tax rates and ceilings that restrict the benefits granted) and the acceptance requirements (obligation to create employment).

The fact that financial activities were expressly excluded from the new regime was a determining factor in line with the favorable direction of the tasks in the Group on the Code of Conduct and the OECD.[48]

In fact, it entails that in the context of the Code of Conduct for Business Taxation the measure relative to the CINM financial activities was being considered, while in the OECD, the conclusion drawn was that, given the modifications introduced in the CINM regime, the harmful activities had been removed.

Nevertheless, a pending issue was the effective date for these activities that in the framework of the previous regime was deemed until 31 December, 2011, which was overcome according to the same terms.[49] In fact, in the political agreement on the Tax Package reached in Ecofin on 20 and 21 January, 2003, a safeguard was especially introduced in Article 33º of the EBF for the effective date of the CINM financial activities' regime defining it until 31 December, 2011, this being the same decision adopted at the OECD.

3.2 Enforcement of the General Anti-abuse Provision.

We shall refer to a specific proceeding in which the Tax Administration understood the enforcement of the general anti-abuse provision was required, as defined in Article 38º, Nº2, of the General Tax Act, having introduced, thereafter, a specific regulation in that respect in Nº10 of Article 46º of the CIRC.

The specific case involved a multiple step transaction, with numerous transactions performed among related enterprises to benefit from abusive tax planning, specifically, the use of the distributed earnings regime foreseen

in Article 46º of the CIRC, through the transformation of the advantages relative to interest earned as benefits inherent in distributed earnings by a registered corporation domiciled in the Madeira Free Trade Zone. In brief terms, it was thought to benefit a non-taxation regime for undistributed earnings, significantly more favorable than the interest taxation regime, employing for that end, a series of consecutive transactions with a number of corporations.

For said effect, the following business assumptions were considered:

a) **Corporation A**, was a stock corporation (SGPS, by the Portuguese acronym) domiciled in Portugal;

b) **Corporation C**, had chartered in the Madeira Free Trade Zone benefiting from the Corporate Income Tax exemption defined by said regime, with 89% of equity ownership held by **Corporation A** and the remaining 11% by **Corporation B,** an SGPS, domiciled in Portugal;

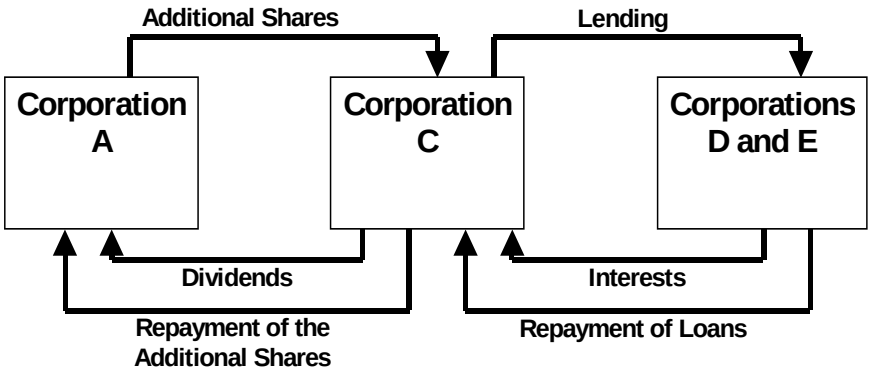
c) **Corporation A** acquired, upon prior discussion by **Corporation C** in that regard, a number of additional shares of equity in this corporation. These additional equity contributions were offset, according to the same dates and amounts, with transfers of funds from **Corporation C** to **Non-resident Corporations D and E**. These transfers accounted for the loans extended, with interest earned on behalf of **Corporation C;**

d) In the term under consideration, the earnings stemming from loans accounted for 99.999999% of the total benefits for **Corporation C**, the rest being made up by bank interests of a residual nature, and not representing exclusively any economic activity that justified the existence of this corporation;

e) In one of the final stages, dividend interests were subject to an economic transaction, distributed by **Corporation C** to shareholding enterprises, by 89% for **Corporation A** and 11% for **Corporation B**. This transaction, for tax purposes and as far as the beneficiaries were concerned, was considered a neutral transaction, based on the tax regime of **Corporation C** and the fact that dividend distribution would benefit the regime to eliminate double taxation on distributed earnings foreseen in Article 46º of the CIRC;

f) In the last stage, the additional equity shares were repaid and the transaction completed, with **Corporation C** receiving repayments from non-resident entities on a given date and for a given amount, which equally transferred funds to **Corporation A** for the amount applicable on that date on the same day, as a repayment for additional shares.

In other words, the following describes the transaction in brief terms:



The Tax Administration reached the conclusion that in such a case, they were faced with a transformation of benefits relative to interest earned from advantages stemming from distributed earnings by a stock corporation resident in the Madeira Free Trade Zone, which warranted subjecting the transaction to the provisions in Article 38º, Nº2 of the General Tax Act, since the dividends distributed by **Corporation C** to **Corporation A** were deemed to be planned operations with the unnecessary use of **Corporation C**, and abuse of legal provisions, geared at eliminating a tax that would otherwise be payable if the interest earned from that allocation of equity had been appropriately entered in the accounting records of **Corporation A**. In the case a stock corporation was not used to benefit from a preferential tax regime, interest would have been taxed as applicable by the Corporate Income Tax in **Corporation A**, to the extent they would be relevant for the calculation of the taxable income.

Based on this conclusion, **Corporation A** could have conducted business activities on its own, since they relied on the human, financial and structural resources, whether directly or through the controlling corporations, which is why it was deemed that the sequence of transactions described were only abusive tax planning practices. The decision was made to deduct the equity increase as defined in Article 46º of the CIRC, instead of pursuing

taxable income advantages as set forth in Paragraph c) of Nº1 in Article 20º of the CIRC. As such, in order to enforce the general anti-abuse provision foreseen in Article 38, Nº2 of the General Tax Act, this was deemed a dividend benefit for **Corporation A** in the form of interest income.

Subsequently, a specific anti-abuse provision was set forth in Article 46º of the CIRC, to see to situations of this nature that as mentioned in 2.6 above, which determines that the regime to eliminate double taxation of distributed earnings does not apply. Should that be the case, the applicable additional tax assessments shall be performed upon concluding that there was an abuse of legal provisions in order to reduce, eliminate or delay tax payments.

4. CONCLUSIONS

From all of the aforementioned, we may essentially conclude as follows:

1. Tax competition is bicephalous, entailing positive as well as negative effects, leading to the erosion of the tax base for certain countries or territories to the benefit of others.

2. Beginning in the ‘80s, there was a disseminated global trend to create preferential tax regimes.

3. The efforts to counter harmful tax competition are increasingly vital in a globalized world, considering the detrimental effects that stem therefrom.
4. Since the 1990s, a new worldwide approach to the issue of harmful tax competition has come into play, the most relevant initiatives being those by the EU with the approval of the Code of Conduct for Business Taxation and the OECD, with the approval of the Report on Harmful Tax Competition Practices.

5. The implementation of anti-abuse measures to avoid the use of tax havens or preferential tax regimes is instrumental in order to face the new magnitude of international tax fraud and evasion.

6. In Portugal, beginning in the 90s, unilateral anti-abuse measures were phased in, especially resorting to a list of clearly more favorable tax regimes to that end.”

7. Mostly taking into consideration the outcomes of the efforts on harmful tax competition conducted by the EU and the OECD, Portugal modified the tax regime in force in the Madeira Free Trade Zone, with the specific elimination, as of 2002, of the practices that enabled a corporation to conduct financial activities such as intragroup services, coordination and distribution centers and treasury.

8. The abuse of preferential tax regimes in certain specific cases has led the Portuguese Tax Administration to introduce new anti-abuse measures.

9. In general terms, the anti-abuse measures introduced in Portuguese legislation have proven to be effective.

NOTES:

[1] The author wishes to thank the prestigious contributions by the Tax General Director, Dr. Paulo Macedo, the Assistant General Director of the Tax Inspection Office, Dr. João Durão, and the Head of the Office of the Tax General Director, Dr. Luís Oliveira Maia.

[2] On international tax fraud and evasion refer to Luís Menezes Leitão, "*Evasão e fraud fiscal internacional,*" AAVV, Colóquio A internacionalização da economia e a fiscalidade, Lisboa, Ministério das Finanças, 1993.

[3] Thus, Jeffrey Owens, Head of the Fiscal Affairs Division of the OECD, who has been involved from the early stages of this project, in an interview by *"L Observateur OECD"*, in December 2000, points out that this organization does not oppose tax competition, acknowledging the beneficial aspect thereof, by which, "*Nos pays membres sont disposés à se livrer à une concurrence loyale dans les activités de services financiers à la fois ouvertes et transparentes. La concurrence fiscale peut avoir des effets positifs. Par exemple, si un pays met en oeuvre une reforme fiscale depuis longtemps nécessaire, cela peut encourager d'autres pays à adopter des réformes analogues afin de ne pas perdre leur compétitivité internationale relative.*»

[4] A question arises in this context based on the definition of harmful tax competition. Is it possible to define in abstract terms with a certain degree of accuracy what is understood by harmful tax competition? We believe not and that is the reason why the European Union and the Organization for Economic Cooperation and Development, the two main institutions that oversee this issue, have not defined it, and only hinted at signals and some example of situations that, *in extremis*, may be described as such.

[5] Preferential tax regimes mostly introduced in the '80s were essentially marked by the reduction of corporate tax with a view to attracting foreign investment. In this respect, please refer to Sílvia Giannini, *"Mercado interno e fiscalidade: aspectos económicos*", Ciência e Técnica Fiscal n. º 401, Janeiro-Março 2001. Relative to Corporate Taxation in the European Union, *vide*, in Portugal, Ana Paula Dourado, A Tributação dos Rendimentos de Capitais: A Harmonização na Comunidade Europeia, *Cadernos de Ciência e Técnica Fiscal* n.º 176, Lisboa, 1996, Paula Pereira, A Tributação das Sociedades na União Europeia. Entraves Fiscais ao Mercado Interno e Estratégias de Actuação Comunitária, *Almedina,* Coimbra, Janeiro de 2004, and Gabriela Pinheiro, A Fiscalidade Directa na União Europeia, *Universidade Católica do Porto*, Porto, 1998.

[6] This is stated by Luís Menezes Leitão, *in,"Evasão e Fraud Fiscal Internacional",* XXX Aniversário do Centro de Estudos Fiscais, Colóquio A Internacionalização da Economia e a Fiscalidade, Lisboa, 26, 27 e 28 de Abril 1993, p.303.

[7] The tax competition phenomenon was officially and specifically analyzed for the first time in the famous Ruding Report.
Up to the '90s, in the European Union, control of harmful tax competition was essentially conducted in a fragmented manner, through the enforcement of the rules on State assistance. In this context, it is of utmost relevance to point out the "new and global" approach of the tax policy set forth by the Commission in the document *A Fiscalidade na União Europeia – Relatório sobre a Evolução dos Sistemas Fiscais* – Brussels 22.10.96 – COM (96) 546 final.

[8] The works by the OECD and the EU were originated from the serious concerns of the G7 at the time. On the other hand, the International Monetary Fund and the World Trade Organization also care about this issue.

[9] Regarding the efforts to control harmful tax competition undertaken in the EU and the OECD, *vide*, in Portugal, António Carlos dos Santos, *"Globalização e impostos – a luta contra a concorrência fiscal prejudicial*", Boletim do Instituto Superior de Gestão, ano 12, n.º20, "*Point J of the Code of Conduct or the Primacy of Politics over Administration"*, European Taxation, vol. 40, n.º9, 2000, *"A posição portuguesa face à regulação comunitária da concorrência fiscal"*, Conferência sobre Fiscalidade Internacional, Universidade Nova, Lisboa, 12 e 13 de Março de 2002, published in the book Planeamento e Concorrência Fiscal Internacional, Fisco 2002, La Régulation Communautaire de la Concurrence Fiscale: una approche institutionnelle, tese de doutoramento apresentada em 2005 na *Université Catholique de Louvain, Faculté de Droit*, en aguardo discusión, António Carlos dos Santos e Clotilde Celorico Palma, *"A regulação internacional da concorrência fiscal nefasta"*, Ciência e Técnica Fiscal nº395, Julho-Setembro de 99, Clotilde Celorico Palma, "*O combate à concorrência fiscal prejudicial – Algumas reflexões sobre o Código de Conduta comunitário da Fiscalidade das Empresas*", Fiscália, Setembro de 99, nº21, "*A concorrência fiscal sob vigilância: Código de Conduta comunitário da Fiscalidade das Empresas versus Relatório da OECD sobre as Práticas da Concorrência Fiscal Prejudicial",* Revisores & Empresas, Jan/ Mar/99, *"A OECD, a concorrência fiscal prejudicial e os paraísos fiscais: Novas formas de discriminação fiscal?"*, Ciência e Técnica Fiscal nº403, Julho-Setembro de 2001 *"A OECD e o combate às práticas da concorrência fiscal prejudicial: ponto de situação e perspectivas de evolução"*, Fiscalidade n.º16, Outubro de 2003, "O controlo da concorrência fiscal na União Europeia", Revista Forúm de Direito Tributário/ RFDT n.º 15, Maio-Junho 2005, *"O controlo da concorrência fiscal prejudicial na União Europeia – ponto de situação dos trabalhos do Grupo do Código de Conduta*", in the process of publication by the School of Economics of the University of Coimbra (Coimbra Publishing House), as part of a collection in honor of Professor Xavier de Basto Xavier de Basto, Nuno de Sampayo Ribeiro, Regimes Fiscais Preferenciais, *Fisco*, Lisboa, 2002 and Freitas Pereira, "*Concorrência Fiscal Prejudicial – O Código de Conduta da União Europeia*", Ciência e Técnica Fiscal nº390, Abril-Junho 98.
Also refer to the papers by the OECD, Jacques Malherbe, *"Harmful Tax Competition and the Future of Financial Centres in the European Union" ,* Intertax, vol. 30, Issue 6-7, 2002, "*Harmful Tax Competition and the European Code of Conduct",* Tax Notes International, n.º21, 2000, Piero Bonarelli, *"L'approccio dell'OCSE nella lotta ai paradisi fiscali – Nuove strategie contro la 'concorrenza dannosa'",* Il Fisco, 21/2002, Terry Dwyer, "'*Harmful tax competition and the future of offshore financial centers, such as Vanuatu",* Pacific Economic Bulletin, May 2001, Marshall J. Langer, "*Harmful Tax Competition: Who are the Real Tax Havens?",* Tax Notes International, 18 December 2000, Tulio Rosembuj, *"Harmful Tax Competition*", Intertax, Vol. 27, Issue 10, 1999, Eric Osterweil, *"The OECD and the EU: two approaches to harmful tax competition"*, The EC Tax Journal, Vol. 3, Issue 2, 1999, Alex Easson, *"The EU and OECD Responses Compared",* The EC Tax Journal, Vol. 1, 1998, Carlo Pinto, *"EU and OECD to fight Harmful Tax Competition: Has the Right Path Been Undertaken?"*, International Tax Review nº 386, 1998, Zagaris, *"OECD Report on Harmful Tax Competition: Strategic Implications for Caribbean Offshore Jurisdictions"*, Tax Notes International, nº 17, 1998, Jeffrey Owens, *"Curbing Harmful Tax Competition. Recommendations by the Committee on Fiscal Affairs"*, Intertax, 1998/8-9.

[10] In its Communiqué on the priorities of tax policy for the forthcoming years (Comunicação da Comissão ao Conselho, ao Parlamento Europeu e ao Comité Económico e Social, *A política fiscal da União Europeia – prioridades para os próximos anos*, COM (2001) 260 final, de 23 de Maio de 2001), the Commissioner notes that "*(...) The general objective of large world economies,*

including those from the EU Member States, is to succeed in defining a fiscal context that promotes free and equitable availability, which contributes to cross-border business activities and concurrently prevents erosion of national tax bases. Along these lines, the struggle against harmful tax competition, undertaken in the last few years in the framework of the OECD and the EU by means of the "fiscal package", is of utmost relevance in the pursuit of this objective."

[11] Published on the JOC 2/2 de 06.01.1998, in Attachment I to the Conclusions of the Ecofin Council on 1 December, 1997, as to tax policy matters.

[12] In other words and as described, the Code of Conduct does not apply to general measures, in which the corporate tax rate defined for the corporations in a country's jurisdiction, such as Estonia, is 0%, or Ireland, where the tax rate is 12.5%.

[13] Based on the name of the chairperson from its origins, Ms. Dawn Primarolo from United Kingdom.

[14] The Group's final report, better known as the "Primarolo Report", was submitted to the Ecofin Council on 29 November, 1999 - Relatório final do Grupo "Código de Conduta " para o Ecofin de 29 de Novembro de 1999 (SN 4901/99, de 23 de Novembro), published in Portugal in the Cadernos de Ciência e Técnica Fiscal n.º185, Lisbon, 2000.

[15] Harmful Tax Competition: An Emerging Global Issue*,* Paris, France, *OECD*, 28 April, 1998. The purpose is essentially based on banking information access practices; Switzerland and Luxembourg refrained from approving the Report.

[16] Please note that the limit between them is blurry, as may be gathered from the respective identification criteria.

[17] The lists of tax havens consists of the Progress Reports from the work of the OECD Forum on Harmful Tax Competition Practices, available on the OECD Web site "Towards *Global Tax Co-Operation – Report to the 2000 Ministerial Council meeting and Recommendations by the Committee on Fiscal Affairs – Progress in identifying and eliminating harmful tax practices*", OECD, 2000, and "*The OECD's project on harmful tax practices: the 2004 progress report". "Towards Global Tax Co-Operation – Report to the 2000 Ministerial Council meeting and Recommendations by the Committee on Fiscal Affairs…*" cit.

[18] On the distinction between evasion and avoidance please refer to Luís Menezes Leitão, *in,"Evasão e Fraud Fiscal Internacional",* XXX Aniversário do Centro de Estudos Fiscais, op. cit., and Sampaio Dória, "*A evasão legítima: conceito e problemas",* Ciência e Técnica Fiscal n. º 143, Novembro 1970, pp. 53 e ss.

[19] On this issue, please refer to Gustavo Courinha, A Provision Geral Anti-abuse no Direito Tributário – Contributos para a sua compreensão, *Almedina,* Abril 2004, pp. 91 a 110. The author, along the lines of Alberto Xavier (Manual de Direito Fiscal, Volume I, Manuais da Faculdade de Direito de Lisboa, *Almedina,* Lisboa, 1981, pp. 279-281), makes further distinctions as to the anti-abuse rules by sector or anti-avoidance conditions by sector, on a less broader basis than the general anti-abuse conditions, but less static than special rules, thus becoming a third independent entity, an example of which is provided in Articles 67.º, n.º10 and 78.º, n.º 11 of the Tax Code for Corporate Taxation (pp. 104 a 106).

[20] On this issue, please refer to Luís Menezes Leitão *"Medidas destinadas a reprimir a evasão fiscal internacional",* Estudos de Direito Fiscal, Almedina, 2001, and *"Aplicação de medidas anti abuso na luta contra a evasão fiscal",* Fisco n.ºs 107/108, Março de 2003.

[21] Refer to the standing regulation in Nº10 of Article 67º of the Tax Code on Corporate Income that sets forth The Taxation of Mergers Directive (Council Directive 90/434/EC, of 23 July 1990, relative to the common tax regime applicable to mergers, divisions, transfers of assets and exchanges of shares of companies from different EU member states, JO L 225, of 20 August 1990), which enables the Member States to deny or remove the benefits stemming from mergers, divisions, transfers of assets with the main purpose of perpetrating tax fraud or evasion or which fail to be grounded on valid economic reasons.

[22] This law approves the Special Tax Regime on Revenue from Debt Securities, overriding the previous regime set forth by Act Nº 88/94 of 2 April.

[23] This law defines the tax regime for securitization and credit transactions performed according to Act Nº 453/99 of 5 November.

[25] On this issue, please refer to Luís Menezes Leitão, *"Aplicação de medidas anti abuso na luta contra a evasão fiscal"*, op cit, and Patrícia Noiret Cunha, *"Measures against 'unfair competition' in the domestic tax system - National Report Portugal"*, Tax Competition in Europe, European Association of Tax Law Professors, International Bureau of Fiscal Documentation, Edited by Wolfgang Schön, pp. 409 to 425.

[26] In the legislative authorization submitted to the Executive Branch by Article 28º of Act Nº 75/93 of 20 December. As noted by Luís Menezes Leitão, *"Medidas destinadas a reprimir a evasão fiscal internacional"*, op.cit. p.162, Decree Law Nº 37/95 did not create measures to restrict treaty shopping, since it understood that it would be inappropriate for this type of measures to be defined domestically. Portuguese legislation does not provide for measures of this type; they are foreseen only in treaties to avoid double taxation subscribed by Portugal.

[27] As elucidated by Luís Menezes Leitão, in *Evasão e Fraude Fiscal Internacional",* XXX Aniversário do Centro de Estudos Fiscais, op. cit., pp. 313, "*These are corporations with the sole purpose of receiving the revenue that would be otherwise directly received by taxpayers for tax reasons, thus safeguarding them from the tax assessment applicable in their country of residence."*

[28] Similar to the OECD statements in the report *"Les paradis fiscaux: mesures prises pour eviter leur utilisation abusive par les contribuables",* and OECD, L´evasion et la fraud fiscales internationales, Paris, 1987, p. 35 to 60 and subsequent, these provisions exist since the 1930's in the United States, after their implementation in a number of countries with very effective outcomes in general terms.

[29] As underscored by Menezes Leitão, "*Medidas destinadas a reprimir a evasão fiscal internacional",* op.cit. p. 167, "*The need to implement this regime in our country was self-evident. In effect, it was unjustified that the Tax Administration, relative to transactions that are statistically known to be simulated and geared at fostering tax evasion, had to prove the simulated transaction in order to collect revenue."*

[30] Excluded from the assessment in this regime are non-resident corporations should the following conditions be repeatedly verified:

a) Respective earnings originating by at least 75% from an agricultural or industrial activity in the territory where they are based or from business activities conducted by other than residents in Portuguese territory or, if so, which are largely geared at the foreign market where they are based;

b) The main activity of the resident corporation is other than any of the following business transactions:

1) Transactions inherent in banking institutions, even when they are not conducted by lending institutions;

2) Transactions relative to insurance companies, when the respective income arises largely from insurance on assets located outside the corporation's territory of residence or insurance for individuals who live outside the territory;

3) Transactions relative to shares or other securities, entitlements of intellectual or industrial property, rendering of information regarding expertise gained from activities in the industrial, commercial or scientific sector or technical support services;

4) Leases, except for real estate located outside the territory of residence.

[31] This article was governed by Record Nº 1446-C/2001 of 28 August.

[32] According to the definition in Article 58. º, Nº4 of the CIRC, relative to the transfer pricing rules.

[33] As explained by Luís Menezes Leitão, *"Aplicação de measures anti-abuse na luta contra a evasão fiscal",* op. cit, p. 42, *"in said case, the resident corporation performs two roles, shareholder and creditor, and since the tax regime applicable to the payment of interest is more favorable than the distribution of earnings, there is a trend to replace the equity increase in resident corporations with credit financing, which enables the erosion of the tax base."*

[34] Council Directive 90/435/EC, of 23 July 1990, relative to the common tax regime applicable to earnings distribution by subsidiaries to their respective parent corporations from different Member States (JO L 225, de 20.08.1990), as amended by Council Directive 2003/123/EC, of 22 December 2003 (JO L 7, de 13.01.2004).

[35] By Article 29º, Nº1 of Act Nº *55-B/2004, of 30 December*, which approved the Government Budget for 2005.

[36] In p.139.

[37] The embodiment of an anti-abuse provision occurred upon the introduction of Article 32º A into the Tax Procedural Code, (CPT, as per the Portuguese acronym) at the time, according to Act Nº 87-B/98 of 31 December (Article 51º, Nº7); it then became part of the General Tax Act as provided by Act Nº 100/99 of 26 July, Article 38º, Nº2. This shift of the general anti-abuse provision to the General Tax Act was merely of a formal nature, since the respective content was reproduced *ipsissima verba*.

[38] On this topic, refer to Alberto Xavier, Manual de Direito Fiscal, op. cit., pp. 272 e 273 e Direito Tributário Internacional, Almedina, 1993. In this last paper, prior to the introduction of the general anti-abuse provision in the Portuguese legal and tax system, he wrote on Page 332, after a comparative analysis from different countries with provisions of this type, that "*In our country there is no general provision of the type mentioned before, relative to harmful domestic or international practices or –and this by virtue of the principle of taxation typology- which, by reflecting the principles of legal certainty and protection of trust, is controversial for its flexibility and the broadness of the provisions therein."* As highlighted by Saldanha Sanches, Manual de Direito Fiscal, *Coimbra Editora* 2002, 2ª edição, p. 121, "*It may be stated that the existence of this rule amongst us necessarily requires a more efficient performance by the Tax Administration, specifically as to the response given to taxpayers' claims, a greater technical capacity to ground decisions and a legal system that, for a given response, evidences an enhanced understanding of the matter of Tax Law."* On the general anti-abuse provision *vide* Carvalho Fernandes, "*Alcance do regime do art.º 32.º A do Código de Processo Tributário e a simulação fiscal",* Direito e Justiça, vol. XII (1999), t.2, p.148, Saldanha Sanches, *"Abuso de direito em matéria fiscal: natureza, alcance e limites",* CTF n.º 398, Abr/Jun 2000, Leite de Campos, *"Evasão fiscal, fraud fiscal e prevenção fiscal",* AAVV, Problemas fundamentais do Direito Tributário, Lisboa, 1999, pp. 189 e ss, António Lima Guerreiro, Lei Geral Tributária Anotada, *Editora Rei dos Livros,* pp. 183 a 190*,* Gonçalo Avelãs Nunes "*A Provision Geral Anti-abuse de Direito em sede fiscal – art.º 38.º, n.º2, da Lei Geral Tributária- à luz dos princípios constitucionais do direito fiscal*", *Fiscalidade* n.º 3, Julho 2000, Sofia Gouveia Pereira, "*A fronteira entre a poupança fiscal lícita e ilícita: antes e depois da introdução da provision geral anti-abuse",* Direito e Justiça, vol. XIV, t.2 (2000), pp. 215 e ss e Gustavo Courinha, A Provision Geral Anti-abuse no Direito Tributário – Contributos para a sua compreensão, op. cit.

[39] Article 39º of the General Tax Act, dwells on the issue of simulation, defining that, in the case of simulation of a legal business, taxation affects the actual legal business and not the simulated legal business.

[40] Quoting Lima Guerreiro, op. cit., p. 188. Just as highlighted by Gustavo Courinha *in* op. cit. p.15, the general anti-abuse provision is the only dynamic response in the Portuguese tax system to counter tax avoidance.

[41] As pointed out by Lima Guerreiro, in op. cit, p. 183, this provision resembles paragraph 41º, Nº 1, in the *"Abgabeordnung"*, which sets forth the irrelevance of the inefficacy of a legal business for the purpose of taxation provided that the parties enable the economic result to endure.

[42] By the terms defined herein, the Tax Administration has been vested with the power to access all the bank information or records regardless of the approval of the holder thereof:

a) In the case of evidence of tax crimes;

b) When there are specifically identified events that indicate the illegitimacy of the taxpayer.

It shall also directly access bank records when these are supporting documents of accounting records of Income Tax and Corporate Income Tax Taxpayers pertaining to formal accounting practices.

The Tax Administration still has the power to access all the banking documents, except for information submitted for credit-rating purposes, in the cases of refusal to disclose the documents or to authorize access thereto:

a) When the absence of direct and accurate control and assessment of the tax base is verified, and in general terms, upon verifying the assumptions that warrant indirect examination; b) Upon verifying the situation foreseen in line f) of Article 87º or that returns filed with the IRS are significantly different, without any justified reason, from the revenue patterns that may be reasonably justified by the evidence of taxpayer's wealth, according to the terms in Article 89º A; c) When it is deemed necessary for tax purposes to prove the benefit of government subsidies of any nature.

[43] As to the Madeira Free Trade Zone regime or Madeira International Business Center and their standpoint in the work on harmful tax competition performed at the EU and the OECD, *vide,* Ricardo Borges, Fernando Brás e Patrick Dewerbe, *"The Madeira Free Zone and its standpoint within the European Union"*, Fiscalidade n.º16, Lisboa, Outubro de 2003 and by the author of this paper, *"O novo regime fiscal do Centro Internacional de Negócios da Madeira",* Semanário Económico de 5 de Junho de 2003, *"O novo regime fiscal do Centro Internacional de Negócios da Madeira – Enquadramento e características fundamentais"*, Fisco nº 107/108, Lisboa, Março de 2003, Ano XIV, and *"Características fundamentais do novo regime fiscal do Centro Internacional de Negócios da Madeira",* Revista TOC n.º42, Lisboa, Setembro de 2003.

[44] Based on this fact, Madeira has never been officially listed as a tax haven, whether by the EU, the OECD, or other international agencies, such as the FATF.

[45] As known, pursuant to the terms in the current Article 87º of the Treaty (formerly Article 92º), there is a general ban on the principles relative to the concession of the so-called State subsidies. As specific exceptions to this general ban on State subsidies, Article 87º, in Nº 2 and 3 respectively, defines the cases in which said subsidies "are compatible with the common market" and "may be compatible with the common market". Among the modalities of this type of subsidy, it states, for the purpose of this document, in line a) of Nº 3 in said legal provision, the case of *" subsidies geared at promoting economic development in regions in which the standard of living is abnormally low or where there is a serious situation of underemployment."* This type of subsidies may be considered compatible with the common market, and requires notification by the Member State to the Commission for approval thereby. On this issue, see António Carlos dos Santos, Auxílios de Estado e Fiscalidade, *Almedina,* Novembro de 2003, Patrícia Silveira da Cunha, Auxílios de Estado Fiscais e Princípio da Não Discriminação Fiscal, *Estudos Jurídicos e Económicos em homenagem ao Professor João Lumbrales,* Coimbra Editora, 2000, Margarida Mesquita, O Regime Comunitário dos Auxílios de Estado e as suas Implicações em sede de Benefícios Fiscais, *Cadernos de Ciência e Técnica* Fiscal nº 158, Lisboa 1989.

[46] Which came to bear influence on the "*Commission communication on the enforcement of rules relative to state subsidies on the measures regarding direct corporate taxation.",* published on 10 December, 1998, as well as the "Changes in the Guidelines on State Subsidies with Regional Purposes, in order to consider Nº 2 of Article 299º of the CE Treaty on Ultraperipheric Regions of the Union", published on 9 September 2000.

[47] Regarding the Code of Conduct, Portugal never agreed with the "qualification" of harmful attributed to the financial activities of the CINM regime in the Primarolo Report, especially highlighting the lack of a thorough analysis on the respective proportionality as to the economic objectives set forth, that is, in the context of Item G of the Code. In fact, according to the provisions in Item G, referring to the eventual application of a given measure to a specific region being deemed potentially harmful as defined in Item B of the Code, its harmful nature may be immaterial against an ulterior motive- the economic development of that region.
For that purpose, it is relevant to prove that tax measures are proportional and geared at the desired objective, the Commission being especially sensitive to the submittal of economic data of a quantitative nature, specifically the employment created in the region.
In this context, Portugal delivered two reports, one of them quite extensive with economic data of a quantitative nature gathered by the Government of the Autonomous Region of Madeira, in the terms by which the proportionality of the regime is proven. To the present, these reports have never been duly analyzed. In fact, contrary to the procedure foreseen in Item G of the Code of Conduct, the Group failed to analyze the issue relative to the proportionality of the measure against the economic objectives defined, since the second

report submitted was never discussed by the Group. In fact, contrary to the procedure adopted relative to all the other reports submitted by the other Member States, the Chairlady concluded, after distributing the report to the Member States that her silence translates into the approval regarding the assessment of the measure as harmful. This was the basis for the following footnote to be included in the Primarolo Report on Page 12 (Nº 8): "*The Portuguese Delegation requested that Nº 32 (on the positive assessment of the measure by the Group) be modified with the addition of the wording "exclusively based on the assessment by the criteria in Item B of the Code", so as to clarify that measure B6 was not assessed according to the terms in Item B of the Code". In fact, none of the Member States gave their opinion on the concept of proportionality relative to measure B6 according to the terms in Item G of the code, neither on the assessment of measure B6 on the ultraperipheric condition of Madeira, nor the content of the report submitted by Portugal on this issue; therefore, it is deemed impossible to assume the principle that this general silence on the matter may mean, in any case, that measure B6 was duly assessed in the framework of Item G in the code."*

48 In the OECD case, it is relevant to highlight that in the Forum Progress Report of June 2000 ("Towards global tax co-operation, Report to the 2000 Ministerial Council meeting and recommendations by the Committee on Fiscal Affairs…" cit.), a number of aspects of the regime were temporarily marked as potentially preferential. Moreover, the Forum Progress Report of 2004, "The OECD's project on harmful tax practices: the 2004 progress report", cit., expressly points out that CNIM preferential regimes were removed, but the effects thereof may continue until 31 December, 2011 with regards to past beneficiaries.

49 According to the Commission's authorization of the State subsidies, said measures may generate effects until 31 December, 2011, raising the issue of to what extent it is possible to abide by this date considering the efforts undertaken as to harmful tax competition. In this regard, Portugal has always argued that the CINM regime is a specific State subsidy regime to a small ultraperipheric island, which from the onset was conceived as a program with effects that would extend to 31 December 2011, on the grounds of the vested rights stemming therefrom. In this context, considering the principle of economic and social cohesion and specifically as defined in Nº2 in Article 299º of the Treaty and bearing in mind the vested rights, we have always sustained that said effective date was to be respected, which was in fact so.

Case study

TOPIC 3.2

THE STRUGGLE AGAINST HARMFUL TAX PRACTICES JOINT ACTIONS AND UNILATERAL MEASURES

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CONTENTS: Introduction.- First Part: Joint Initiatives Carried Out in the Sphere of the OECD and the European Union Aimed at Preventing Taxpayers from Shifting their Earnings to the So-Called Tax Havens.- Second Part: Current Measures in Force in the Italian Legal System to Counter So-Called Harmful Tax Practices.- Conclusion.

INTRODUCTION

Before I start my presentation, I would like to thank the Executive Secretariat of CIAT and the Organizing Committee of this 40th General Assembly, who are concluding their work today, for the opportunity offered to a representative of the Italian Administration of speaking at this venue on the topic of today's session.

Since I am the last speaker of the day, I will venture to suggest a kind of common denominator in the topics discussed, which lies – in my opinion – on reasserting that the path toward combating harmful tax practices is, no doubt, that of international cooperation which shall provide the framework for an increasingly intensive exchange of information which will be far from an end in itself, but rather an essential tool capable of providing a strategic scope to tax policies as considered individually. In effect, the function of tax policies continues to be ensuring effective and correct collection of public revenue due to the Government or other duly established territorial public entity. In this sense, the need to continue on the path toward strengthening exchange of information among administrations is not only a requirement for EU-member countries and the Organization for Economic Cooperation and Development itself but also represents, and duly so, one of the main purposes of the Inter-American Center of Tax Administrations as the appropriate forum to exchange experiences among member and associated countries and provide and receive assistance to improve every administration, while responding to each administration's requirements.

After the acknowledgment I believe was in order to CIAT and its Secretariat, which organized the meeting, let me turn to the topic of my presentation.

In the first part of my presentation, I deem it necessary to refer, however briefly, to the joint initiatives carried out in the sphere of the OECD and the European Union aimed at preventing taxpayers from shifting their earnings to the so-called tax havens and, in turn, encouraging said jurisdictions to eliminate tax privileges for non-residents. In the second part, I will provide an analysis of Italian regulations, that is, I will present current measures in force in the Italian legal system to counter so-called harmful tax practices.

As a premise, I would first like to make reference to the concept of "tax haven", which has been often abused.

From the fiscal perspective, tax havens are countries where the level of taxation is at least 30% lower than the average level applicable, for instance, in Italy, considering that the European average stands at around 46.2% (with a minimum of 34% in Greece and a maximum of 55% in Sweden).

In the late 80's, the OECD, as the champion of fiscal harmonization at the international level, controller and guarantor of equitable economic growth among countries internationally, within the framework of its control and social policy development efforts, started to stigmatize the countries considered tax havens. Originally it did so through what came to be called

the “Reputation Test”, which was based on merely subjective – reputation – criteria. The OECD thus clearly isolated the countries which enjoyed lenient fiscal treatment. In that first document, “tax havens” were characterized as such by virtue of their international reputation as such.

As I shall discuss later, based on OECD principles, harmful tax competition materializes mainly through tax havens defined as jurisdictions where:

- there is null or purely nominal, but ineffective, taxation;
- there is no effective exchange of information with other countries;
- there is no transparency in legislative and administrative provisions;
- in granting fiscal benefits, there is no requirement for the activity being carried out in the country to be substantial in nature.

Regarding the phenomenon of tax havens, one of the principles which became increasingly deep-rooted is that relative to the requirement of convergence between international, bilateral and national actions. The convergence of these actions is currently considered essential in promoting areas of transparency and effective exchange of information. In fact, adoption of international principles and/or duties arising from multilateral and bilateral agreements is a strategic aspect to this process although at the same time it is obvious that it is impossible to avoid altogether a few tools at the national level which are capable of providing more security in countering so-called harmful tax practices.

Nevertheless, I should point out the actions and efforts undertaken by many jurisdictions to respond to the different international appeals for their opening up. Although this process has not been completed yet, it required – and still does – strong determination, on-going commitment and considerable effort to change some of the internal regulations and existing practices in order to adopt appropriate behaviors to ensure transparency and effective exchange of information, and stop the phenomena of avoidance and/or evasion. Likewise, in this framework, individual actions against avoidance at the level of national legislation also act as motivation for any other jurisdiction where the principles of transparency and exchange of information have not yet been adopted completely.

But let us now turn to the major initiatives undertaken in the sphere of OECD and the European Union.

FIRST PART

As I said earlier, the different initiatives implemented since the late 80's both in the sphere of the OECD and the European Union have been developed in the framework of specific actions aimed at hindering harmful tax practices existing in some legislations which, by virtue of current tax regulations, favored and continue to favor, although increasingly less so, the concealment of capital and gains by foreign investors.

In the OECD front specifically, it is possible to distinguish two phases in this process geared toward eliminating so-called harmful tax practices. A first phase of OECD actions started in the 90's and continued throughout the decade especially aimed at identifying tax havens: the 1998 OECD report on harmful tax practices materialized precisely in the imposition by geographical area of the so-called mobile financial capitals and remaining services on activities. In particular, as has been said already, OECD documents referred to al least 4 distinctive features of so-called tax havens:

1. null or purely nominal, yet ineffective, taxation;
2. no effective exchange of information with other countries;
3. no transparency in legislative and administrative provisions;
4. in granting fiscal benefits, no requirement for the activity being carried out in the country to be substantial in nature.

The first criterion – **the complete lack of taxes or nominal taxes on income** – was initially considered the first and absolute condition – sufficient in itself – for a jurisdiction to be identified as a tax haven.

The second factor – **lack of exchange of information** – characterized instead the lack of willingness of the jurisdiction to exchange information on tax matters with the tax administrations of other countries committed to combating tax avoidance and evasion. Said criterion is reflected, for example, in the ban to banking and/or financial access and exchange of information within said jurisdiction.

Lack of transparency, the third criterion mentioned, mainly refers to an effective inability by the jurisdiction to offer detailed information on its own tax provisions and the preferential regime adopted by said jurisdiction relative to specific taxpayers.

Finally, **the absence of the requirement in connection with the need to carry out substantial activities in the jurisdiction** was defined as the set of tax privileges granted to foreign companies which either lack a significant presence in the jurisdiction or do not contribute significantly to the development of the local economy – the so-called “ring fencing”.

The 1998 OECD report, which established the Forum on harmful tax practices, identified tax havens based on these principles and prepared a list of over 40 jurisdictions which met said criteria one way or another, so much so that it became necessary to exert coordinated intervention in the way of defensive measures. It is a known fact that the first version of the OECD list of tax havens was later reduced to 35 jurisdictions by virtue of the commitment undertaken by some of these jurisdictions to eliminate said harmful tax practices and adopt the measures recommended by the 1998 OECD report.

I made reference to this historic evolution because I would like to draw your attention to the fact that it has not been possible to immediately achieve a general agreement on the characterization of tax practices as “harmful”. In fact, after much discussion, the principle of the absence of direct taxes or the level of taxation to be applied was eliminated, thus respecting the right of each system to establish its own level of internal taxation. A general acceptance of the principle resulted, based on which the characteristic mentioned could be used to qualify a regime as a tax haven inasmuch as said factor was accompanied by at least one of the other factors:

– lack of exchange of information;
– lack of transparency;
– absence of the requirement relative to substantial activities carried out in the jurisdiction.

The next step was the decision in the sphere of the OECD not to apply the requirement relative to substantial activities, precisely due to the difficulty in determining an accurate definition for “substantial”.

All of these changes confirm the difficulty there has been to date in clearly characterizing a system as a “tax haven”. Thus, at present, the OECD itself makes reference basically to two conditions in order to qualify a jurisdiction as a tax haven, namely:

– lack of exchange of information;
– lack of transparency.

The exchange of information is currently based on the principle whereby, based on specific agreements and conventions among countries, competent authorities on tax matters are granted the right to request information for specific purposes. In this context, let me remind you that precisely relative to exchange of information, the new language of Section 26 of the OECD Model Convention on Income Tax and Capital includes banking information under exchange of information.

The requirement of transparency, on the other hand, refers to the commitment by jurisdictions to eliminate from their internal regulations any element departing from international accounting standards and generally accepted conventions on tax matters such as, for instance, "secrecy" regarding the *tax ruling*.

The second stage of OECD actions started in 2000, upon the end of the deadlock resulting from the discussion and the need to seek consensus regarding the notion of "tax havens" and, especially, harmful tax practices. Said actions were carried out precisely with a view to identifying appropriate intervention and "reaction" mechanisms vis-à-vis harmful tax practices. The 2000 OECD report recommends taking action in three major directions – national legislation, bilateral and multilateral agreements on tax matters and international cooperation actions. Among these, I will now refer to defensive measures which are generally adopted by countries vis-à-vis "uncooperative tax havens". Said measures usually include one or more of the following instruments:

- eliminating deductions, exemptions or credits relative to payments made by residents in countries applying harmful tax practices;
- *thin capitalization rules;*
- *controlled foreign corporation rules;*
- restrictions relative to *participation exemptions* or *foreign tax credit;*
- *transfer-pricing rules*, and
- *information-reporting* relative to transactions involving *uncooperative tax havens* or those benefiting from their harmful tax practices.

As you can see, the purpose of these defensive measures is basically to increase the cost of shifting earnings to favorable tax systems or, in other words, to combat "bogus" placement of earnings, rather than to penalize earnings coming from these jurisdictions. But I will revisit this aspect in the second part of my presentation, when I shall refer to Italian legislation on the subject of controlled foreign companies.

Let us now consider the most recent OECD actions. In effect, I would like to refer, on the one hand, to the development of the OECD model convention on exchange of information, of which we are currently both witnesses and players, and to which bilateral and multilateral agreements resort increasingly often; and, on the other hand, to the emergence of an increasingly generalized consensus on the notion of a "*global level playing field*" and, in turn, to the need for the simultaneous presence of unilateral, bilateral and multilateral actions.

On the new listing published by the OECD in 2004 regarding "uncooperative tax havens", in addition to its content, it is especially necessary to note that a significantly reduced list evolved thanks to the commitment undertaken by at least 31 jurisdictions to ensure full observance of the principles of transparency and exchange of information. On the other hand, at the recently held Global Forum of Melbourne (November 2005) it remained clear that if a country decides to use a list of countries derived from the OECD list it should do so on the basis of relevant and true facts. This means that said country shall also take into account the implementation of the principles of transparency and the effective level of exchange of information applied in the jurisdiction. But I shall come back to this point later. By way of closing of the first part of my presentation, I would like to make brief reference to the initiatives undertaken by the European Union relative to combating harmful tax practices.

In particular, I would like to briefly point out the effort made by the European Union since the late 90's in preparing the so-called Code of Ethics. As you know, since the Treaty on European Union does not foresee specific provisions on uniformity of direct taxes, fiscal coordination is a particularly difficult endeavor. Direct taxation shall of course respect the four freedoms established in the Treaty (free circulation of goods, persons, services and capitals), as well as establishment rights both for persons and companies.

As regards the most widely used techniques to discourage the use of tax arbitration, I can mention the rules against thin capitalization, which foresee that loan interest is not deductible. In particular, said regulations against thin capitalization attempt to prevent the shifting of taxable matter from countries with high tax pressure to others with lower tax pressures. In effect, expenditures incurred on the interest paid on financial loans are generally used to reduce the taxable base. Similar tax maneuvers are used to shift profits from countries with high taxation to countries with lower taxation and, therefore, place profits in the latter. The main harm caused by these tax avoidance maneuvers is the loss of tax revenue for national governments which try to stop them through their power to impose direct taxation.

Conversely, indirect taxation requires a high level of harmonization, since it refers to free movement of goods and free service provision. Since 1992, harmonization of indirect taxation has evolved decisively with the addition of the new excise system ("*accisa*") and the intra-community value added tax, based on the elimination of tax and customs borders, as well as border customs controls amongst member states.

The Code of Ethics I alluded to is inserted in this context and constitutes the result of the need for joint European action to counter harmful tax competition with the purpose of contributing to a completely neutral tax factor. Therefore, the Code of Ethics is one of the instruments added with the purpose of limiting negative phenomena associated with the shifting of profits to the so-called "areas of lower taxation". From the strictly legal standpoint, it is not a binding tool, although this does not mean that the States can ignore it, since it is a document they are subject to by virtue of the provisions it contains.

Also noteworthy is the fact that the Code is applicable exclusively to corporate taxes. This means that the Code applies to all tax measures adopted in the legislative or administrative field which might lead to effective taxation lower than generally applicable in the interested State, said level of taxation being determined either by the regulations relative to the tax base or by rates or any other relevant element.

The Code foresees a commitment on the part of countries not to include in their regulations any harmful type of taxation and to eliminate those which might still exist by means of an internal monitoring of sorts, both of the regulations and of existing practice. The latter reference appears compelling, since it imposes on the States the duty to further consider "how" a regulation is actually applied regardless of its language.

In this connection, it is of utmost importance to bear in mind that the internal monitoring has an external counterpart performed by the remaining countries of the Community by legislation in force or in the process of being adopted by said countries. This monitoring is performed by exchanging information voluntarily or upon request if the Applicant State deems that the benefits offered by the regulations are potentially harmful.

This exchange of information allows for very rigorous mutual control, given that each country may not only seek clarification regarding the tax regulations that might be in the purview of the Code but also discuss regulations which grant benefits upon assessing their repercussion in the common market. One of the few exceptions allowed lies in the local or

regional facilities adopted as support to specific regions in cases where they are considered compatible.

As you know, there is a Group in charge of controlling the production of regulations in each member country, which group is composed by representatives from each State and the Commission, which further assesses the potentially harmful nature of tax regulations submitted for its consideration. The Group presents regular reports on the tax measures submitted for analysis, which are remitted to the Economic and Financial Council by resolution and, if the latter deems it advisable, these resolutions are published.

Likewise, the Code foresees that, in case tax measures are used with the purpose of supporting economic development in certain regions, an assessment is in order to ascertain whether they are proportional vis-à-vis the objective to be reached and whether they are aimed at said objective. In the sphere of this assessment, special attention is given to the characteristics and needs of ultra-peripheral regions, without affecting the integrity and consistency of the Community's legal system, including internal market and common policies.

The Code adds that "the principles aimed at eliminating harmful tax measures shall be adopted in the widest possible geographical framework. To this end, member States undertake to advance its adoption in third countries and in the territories where the Treaty is not applicable".

The objective set forth by the Code is therefore somewhat ambitious: it wishes to represent a political tool capable of influencing internal legislation, while it fails to adopt community measures, thus choosing the institutional path.

It is clear that the common denominator behind OECD and European Union actions is that their ultimate goal is not that of eliminating tax competition itself, but exclusively distortive tax competition, which undermines the foundations of any tax harmonization effort; that is, the kind of tax policy seeking only to remove tax base from other States, granting specific tax benefits to foreigners and creating a true barrier to exchange of information.

By this I mean that the EU and OECD anti-haven strategies I mentioned in the first part of my presentation are not specifically reduced tax rates as such – which should therefore be considered a totally acceptable form of competition – but only and exclusively "the tax policies aimed at **removing taxable matter from other States by fraudulent means.**"

Let us now turn to the analysis of national legislation on the matter.

SECOND PART

There are multiple agreements in force in Italy, which have been signed by the country based on the principles provided for in Section 26 of the OECD model to avoid double taxation and perform simultaneous tax audits pursuant to EEC Directive 77/799.

In the field of multilateral actions, Italy has widely contemplated community regulations in its legal system to appropriately enforce tax rules and combat tax fraud. In effect, in an attempt to promote collaboration and cooperation among European Union States with the purpose of ensuring correct enforcement of tax rules and repressing tax offenses, a number of specific domestic provisions were passed over the years aimed at regulating the field. It is a known fact that current community regulations on exchange of information and mutual assistance between and among the tax authorities of EU-member States arise from EEC Directive 77/799*/EEC* of 19 December 1977, amended by EC Directives 2003/93/EC, 2004/56/EC and 2004/106/EC, regulating the field of direct taxation and the tax on insurance premiums, as per regulation 1798/2003 of 7 October 2003, its purview being limited to value added tax and regulation 2073/2004 of 16 November 2004, relative to cooperation in the field of excise duties ("*accisas*").

At the time of reception of the new community system, the necessary changes to national provisions were contributed (Decree from the President of the Republic # 600/1973, Decree from the President of the Republic # 633/1972 and Law # 1216/1961), regulating the assessment of income tax, value added tax and the tax on insurance.

Considering what I have stated, Italy keeps *black lists* based on internal provisions I shall comment in detail later.

Let us now turn to the so-called **controlled foreign companies**. Legislation on controlled foreign companies is, no doubt, the most successful kind of anti-avoidance regulation and, in fact, it represents the most widespread anti-haven type of regulation currently in force. As you know, the most distinguishing feature of this regulatory orientation is the fact that, irrespective of the different enforcement modalities adopted by the different countries, it foresees that income generated by a controlled company is subject to taxation by the state of residence of its holding company, if the

former resides in a country where it is subject to a favorable regime vis-à-vis that of the state of residence of its holding company. This is so regardless of whether the foreign controlled company has effectively distributed said income.

It is obvious that this kind of regulation does not seek to prevent the use of "tax havens" or, at any rate, countries offering specific benefits for foreign businesspersons, but rather to avoid the accumulation of corporate income in a State with low or null taxation which is never transferred and, therefore, subject to normal taxation under the holding company. From this perspective, one notes that legislation in force in Italy on the field of controlled foreign companies was passed with the specific purpose of avoiding fictitious placement of earnings rather than penalizing earnings coming from these jurisdictions. National legislation offers the possibility, as we shall see further on, of submitting a requirement as well as of proving the non-fictitious nature of activities carried out in countries where there is decidedly lower taxation - as compared with Italy - and with which there is no adequate exchange of information.

From this perspective, I would like to call your attention to the fact that the anti-avoidance and anti-fraud regulations we are discussing do not have a discriminatory intent against one or several countries, neither can one presume that their purpose is to attract foreign income. Their purpose, as I just stated, is to penalize fictitious placements. Now, whether some foreign earnings – that is, only the earnings received in certain jurisdictions – rather than all of them are subject to said regime depends, I insist, on whether said earnings are received in jurisdictions having remarkably lower taxation than Italy and with which there is no adequate exchange of information. These two criteria [(a) taxation remarkably lower than in Italy and (b) lack of adequate exchange of information] are, in fact, the reference criteria of national regulations.

It should be repeated at this juncture that every time we face phenomena of this kind, there is no gain on the part of the jurisdiction with privileged taxation or tax haven in the sense that, inasmuch as there is a fictitious placement of earnings, the country is not receiving revenue, but simply favoring the failure to pay taxes in another country.

As a first thought about the Italian legal system, allow me to call attention on the circumstance that the Italian system is based on the model called *jurisdictional approach* which, as you know, unlike the *transnational approach*, is characterized by the fact that the earnings of the foreign controlled company relate unitarily to the resident controlling company,

irrespective of the sources where it comes from. Thus, the Italian system, as most regulatory systems adopted by many European countries, France in the first place, is based on defining one or more parameters aimed at identifying countries or systems deemed "privileged" by listing them specifically and comprehensively. Actually, based on the jurisdictional approach, once it is established that the foreign State of reference is part of the "incriminated", all earnings of the controlled company established in said State are associated to the national controlling company. On the other hand, the *transnational approach* makes exclusive reference to the type of earnings and, in particular, *passive earnings;* that is, earnings arising not from an actual economic activity but from the productivity of easily moved goods, such as typically, financial income (interest, royalties, dividends, capital gains on the transfer of equity, etc.)

But let us analyze in detail the specific content of the rules on CFCs currently in force in Italy. It is evident from Italian national legislation that Italian legislators orient the obstacles to the shifting of income to territories with privileged taxation mainly through two regulations:

- Sections 167 and 168 of the TUIR (Income Tax Consolidated Text, acronym in Italian), which encompass CFC regulations;
- Section 110 of the TUIR, which limits the deductibility of the negative components of income, regarding transactions with companies domiciled in certain nations.

On this point, it should be clarified that said rules are the end result of a gradual process which started in the early 90's, aimed at introducing anti-abusive provisions to prevent unorthodox behaviors consisting in deducting fictitious or bloated negative components within international shareholding groups with associated companies located in countries with low or inexistent taxation (Section 76 of the TUIR – Law # 413 of 1991). However, this rule posed certain limitations from the beginning inherent to the fact that it was only aimed at shareholding groups, while the flow of fictitious costs could come from apparently independent taxpayers, but which were actually maneuvered through trust shells. For that reason, following OECD instructions, national legislators changed the provision in 2000, to render non-deductible "the costs and other negative components of income derived from transactions with companies, even if they are not corporations and not necessarily part of the same group".

The reason for the Italian rule, like that behind the discipline of CFCs in other national legislations is to provide a solution to an international

avoidance phenomenon - tax deferral – that is, the production of income in low taxation countries avoiding its distribution under the form of dividends or profits.

The new Section 167, which reformulates Section 127 bis of the old Tuir, only regulates controlled foreign corporations, whereas the new Section 168 widens the scope of enforcement of CFC regulation to include cases where the subject residing in Italy has, directly or indirectly, through a trust company or by a third person, a share no lower than a certain percentage of the earnings of a company residing in states with a preferential tax regime.

The share percentage should not be lower than 20% in the case of private companies and 10% for listed companies.

The earnings of the non-resident company are determined by an amount representing the higher amount between earnings before taxes arising from the balance sheet of the controlled foreign company, and an income determined inductively based on yield factors associated with certain categories of goods.

Section 167, Paragraph 1 of Decree from the President of the Republic # 917/1986 (relative to Section 127 bis, Paragraph 1 of the language in force up to 31 December 2003) provides that “if a subject residing in Italy has either direct or indirect control, through a trust or by a third person of a company, a corporation or other entity residing or located in States or territories with privileged tax regimes, earnings obtained by the controlled foreign company shall be charged, as from the close of the fiscal or business year of the controlled foreign company, to the resident taxpayers in proportion to their respective shares. Said provisions are also applicable to shares in non-resident companies with respect to the earnings derived from their permanent establishments subject to said privileged tax regimes”.

The CFC rule applies to Italian resident taxpayers having direct or indirect control of a resident taxpayer located in one of the States or territories identified in the black list approved by ministerial decree.

Based on the second paragraph of Section 167 in the New Single Language, the CFC rule is applicable to:

- Resident individuals;
- Taxpayers referred to in Section 5 of the TUIR (partnerships);
- S.p’s (Partnerships), s.c.p.a’s (limited partnerships)., s.r.l. (limited corporations), cooperatives and provident societies as well as other

public and private entities with or without the exclusive or main purpose of performing business activities (Section 73, paragraph 1, a), b) and c) of the Tuir.

On the other hand, the following are excluded from the purview of said regulation:

- Partnerships and entities of all kinds, with or without legal status, which are non-residents of the State (Section 73, paragraph 1, d);
- Permanent establishments in Italy belonging to non-residents or individual foreign businesspersons, except when controlled by a resident person, either directly or indirectly.

By virtue of Paragraph 8 of Section 167 of the Tuir, Ministerial Decree # 429 of 21 November 2001 regulated foreign affiliates. Section 1, paragraph 2 details that by residents or entities located in States or Territories with preferential tax regimes one should understand any entity (companies, corporations or other entities) eligible for preferential regimes.

Pursuant to the second paragraph of Paragraph 1, the new CFC rule also applies to “participation in non-resident companies with regard to the earnings derived from their permanent establishments liable to said preferential tax regimes”.

According to the Italian legislation, the rule is applicable when the resident:

- Has a controlling share, directly or indirectly, of the capital of the second one, “even through trusts or by a third party”, pursuant to Section 2359 of the Civil Code;
- Is a foreign person located in a country having a preferential tax regime.

An important aspect I would like to stress is that of control as established by internal civil regulations (Section 2359 of the Civil Code). In this regard, we should distinguish:

- The so-called control by rights, applicable when a corporation has, directly or indirectly, the majority of the votes that may be exerted in regular meetings of another corporation;
- The so-called factual control, applicable when a corporation has, directly or indirectly, the number of votes necessary to exert a dominant influence in regular meetings of another corporation;

- The so-called indirect control is applicable when even if there is no share ownership to directly influence the activities of another corporation, the latter receives the dominant influence of a third corporation in respect to which the former, in turn, exerts either control by rights or factual control;
- The so-called contractual control, which originates at the time specific contractual bonds are established (C.M. 207/2000).

Ministerial Decree # 429/2001 clarifies that the main date in which one should assess the existence of the control requirement for purposes of the applicability of CFC rules is the "close of the fiscal or business year of the controlled foreign company". Said provision is in accordance with regular practice in the field of partnerships where, for transparency purposes, the profits are charged to the entity which, by the close of the corporation's fiscal year, stands as a partner. The same rule further provides that control prevails even when the number of votes necessary to exert factual control or control by rights (Numeral 1 and 2 of Section 2359 of the Civil Code) is reached by adding all the votes of relatives referred to in Section 5, paragraph 5 of the Tuir.

Paragraph 4 of Section 167 of the Tuir establishes that States or territories with preferential tax regimes shall be identified by Decree from the Ministry of Finance, mostly based on the existence of the two criteria I mentioned at the beginning, namely:

1. **significantly lower taxation than that applicable in Italy;**
2. **inadequate exchange of information.**

The (black) list of relevant countries and territories as regards applicability of the CFC rule is contained in Ministerial Decree 429/2001. This decree breaks down the countries with preferential tax regimes into three categories:

Section 1 identifies the States which are tax havens across their territory. These States enjoy an almost complete exemption system.
Section 2 lists the States which are tax havens although they contemplate the exception of certain types of corporations which meet the conditions of ordinary taxation and, therefore, do not fall under the scope of the measure.
Section 3 identifies States for which the applicability of the rule is exclusively related to specific entities and activities.

Thus, the rule provides for the earnings generated by the controlled foreign company to be charged "for purposes of transparency" to the resident, irrespective of its effective distribution, in proportion to its share in the profits,

be it direct or indirect. However, in the case of indirect participation, one should distinguish whether this occurs through:

- foreign taxpayers;
- taxpayers residing in Italy or permanent establishments in Italy belonging to foreign taxpayers.

The first paragraph of Section 3 of Ministerial Decree # 429/2001 provides that:

- for taxpayers referred to under a), the earnings of the CFC shall be charged pro quota to the Italian taxpayer with indirect control through the foreign taxpayer;
- for taxpayers referred to under b), the earnings of the CFC shall be charged pro quota to the Italian taxpayer or permanent establishment in Italy belonging to the foreign taxpayer through whom indirect control is exerted.

The purpose of the national rule is to establish the charge of foreign earnings, for purposes of transparency, to "the first entity in the control chain" taxable in Italy. In assessing corporate earnings, New Single Language provisions are applicable, except for those contained in Sections 54, paragraph 4 and 67, paragraph 3 for profit subdivision into quotas and accelerated depreciation, respectively, as well as provisions of Sections 96, 96 bis, 103 and 103 bis for issues of foreign dividends, dividends distributed by non-resident corporations, loss carry-forwards to future fiscal years, insurance companies and credit and banking entities respectively.

Section 2, paragraph 2 of Ministerial Decree 429/2001 provides that, in assessing the earnings of the foreign taxpayer, for tax purposes, recognition is given to the amounts resulting from the foreign taxpayer's balance sheet pertaining to the fiscal or business year prior to the first use of the CFC rule.

The last paragraph of Section 2, paragraph 2 of the Decree provides that amortizations and allowances for risks and charges resulting from said balance sheet are considered deductible, even if they differ from those accepted by the Tuir, or if they exceed the deductibility thresholds foreseen in the Tuir.

It should be noted that, since the earnings of the CFC's are not merged with the overall earnings of the resident taxpayer, but entail an autonomous tax base liable to separate taxation, these cannot be presented as an offset for ultimate losses of the resident taxpayer, or vice versa.

The CFC rule contains a number of provisions whose purpose is to avoid the phenomenon of double taxation.

In particular, Section 3, paragraph 4 of Ministerial Decree 429/2001 provides that the distribution of earnings by CFC's does not constitute part of the overall earnings of the resident taxpayer for the quota corresponding to the amount of earnings already charged, for purposes of transparency, to the latter and, therefore already taxed (separately). This provision prevents the same earnings from being taxed under the Italian taxpayer:

- for the first time (separately) for purposes of transparency;
- for the second time (in the ordinary way) in the fiscal year when the distribution actually takes place.

Earnings distributed by the CFC in excess of those already taxed for purposes of transparency become part of the overall earnings of the Italian taxpayer as per ordinary regulations.

From the taxes due on said amount, income taxes paid abroad can be deducted definitively by the CFC. The cost of participation in the foreign taxpayer, pursuant to paragraph 5 of Section 3, is:

- increased by the earnings charged to the Italian taxpayer for purposes of transparency
- and decreased, up to the amount of said earnings, by the profits distributed.

The purpose of this rule is to prevent the same amounts from being taxed under the Italian taxpayer twice: the first time as profits and the second time as capital gains.

The only possibility of avoiding the enforcement of the rule under study, even in the presence of subjective and objective requirements, is to prove that it responds to the cases foreseen by the "reasons for exceptions" referred to in paragraph 5 of Section 167 of the New Single Language. The rule provides for two alternative conditions, in which it is not applicable:

- the first reason for exception is applicable when the resident taxpayer proves that the taxpayer located in the State or territory with a preferential regime effectively carries out industrial or business activities in the State where it is based;
- the second reason for exception is applicable if the resident taxpayer proves that the setting up of the foreign taxpayer was not triggered by

the will to place the respective earnings in States or territories with preferential tax regimes.

To be exempted from the CFC regime, the taxpayer is obliged to first submit a requirement before the financial management: in this case, it is not a power granted to the taxpayer, but a duty. In addition, unlike ordinary requirements, this kind of requirement refers to the assessment of factual circumstances rather than the interpretation of legal rules.

The modalities of enforcement of the filing of the requirement in the area of CFC's are established by Section 5 of Ministerial Decree 429/2001. In particular, paragraph 3 of said Section provides that the taxpayer should prove that earnings obtained by the controlled company were produced in a percentage equal or higher than 75% in other States or territories different from those indicated in the black list, and completely liable to ordinary taxation. The corporation, upon a favorable resolution for the requirement based on the effective performance of an economic activity in the location, shall be exempted from the duty of paying taxes on the foreign earnings for purposes of transparency, based on Section 169 of the Single Language. However, when the CFC distributes dividends, these should be taxed fully, through the holding company, based on Section 101, paragraph 3, with the effect of a double taxation, and without the benefit of the tax credit.

Finally, I would like to explain how the **requirement** works. Regarding the foreign profits distributed by corporations or entities, assuming the foreign taxpayer resides in a country or territory with a preferential tax regime, national legislation provides for total taxation on the dividends received by the taxpayer, without prejudice of the possibility of filing a requirement with the purpose of proving, as per specific modalities (paragraph 5 of Section 167 in the Tuir) that from the beginning of the period of shareholding, the earnings were not located in contexts of preferential tax regimes.

Also outside of the scope of Section 59 of the Tuir are earnings distributions by residents of countries with preferential tax regimes ("Cfc") falling in the purview of the provisions of Sections 167 and 168 of the Tuir ("CFC legislation"), obviously, up to the amount of earnings already taxed separately.

Regarding the relationship between the filing of the requirement on account of the CFC and on account of dividends, it should be clarified that, if the taxpayer has received a favorable opinion regarding the Cfc rule based on the reason for exception foreseen in Section 167, paragraph 5, a) of the Tuir (performance of an effective industrial or business activity by the Cfc),

the profits distributed by the latter are considered in whole as part of the taxable earnings of the resident taxpayer. Nevertheless, the taxpayer is not denied the possibility of filing a new requirement, aimed at enforcing the reason for exception referred to in b), paragraph 5 of Section 167 of the Tuir (placement of earnings in countries with preferential tax regimes).

Furthermore, it seems clear that dividends ultimately exceeding already taxed amounts are liable to taxation in an integral fashion inasmuch as they come from a taxpayer which is part of the “black list”; paragraph 4 of Section 47 provides for integral taxation of the profits distributed by corporations residing in countries with preferential tax regimes, if they have not yet become part of the earnings of the partners for purposes of transparency, as per paragraph 1 of Section 167 or 168(9) of the Tuir.

Finally, on this point it should be clarified that the rule referred to in Sections 47, paragraph 4 and 89, paragraph 3 of the Tuir, is also applicable to the distribution of profits by affiliates or related companies residing in territories or countries with preferential tax regimes, on the portion in excess of profits already charged as per Section 167 or 168 of the Tuir.

CONCLUSION

To conclude, in awareness of the need for tax powers to be used to secure the financial means required for the operations of the State, it is necessary to have both considerations coexist. That is to say, firstly, one should always keep in mind that certainty, equity, efficiency and transparency are assumptions to be observed at all times on tax matters under the rule of law. Secondly, actions of individual, bilateral or collective nature are required to reach adequate levels of transparency and exchange of information on tax matters, in the belief that precisely the latter two instruments are the means required to ensure equitable and healthy competition between tax regimes.

CLOSING SESSION

GENERAL REPORT

GENERAL REPORT

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In the first place, I would like to thank the Receita Federal of Brazil and the CIAT Executive Secretariat for honoring me with their request to draft the general report of this 40th General Assembly, with the theme: *"Potential Collection as a Goal of the Tax Administration"*. In my introduction I wish to underscore the careful and intelligent development of the Technical Program, commend the outstanding speakers, moderators and commentators, as well as the participants who made highly relevant and enlightening interventions. I also wish to highlight the diligent and competent work of the organization of the Assembly and the teams which provided technical and logistics support.

I apologize, as most rapporteurs do, for not citing all the ideas and suggestions that were presented in the course of the conference and discussion sessions, since, as we all know, the underlying principle of general reports implies summarizing and grouping ideas into thematic areas. This is what I will undertake from this point on, in an attempt to be as truthful as possible to the events of the four days of the Assembly, expressing, if I may, my personal view on certain issues.

The 40th CIAT General Assembly was, in fact, a unique time to generate and disseminate knowledge relative to tax policy topics, management by results, tax economy, strategic planning, performance assessment, impact indicators, etc., focusing at all times on Potential Collection as a Goal of the Tax Administration. Once again, we bore witness to the role of CIAT as an integrator of the tax administrations of its member countries, a driver of change and organizational improvement and, above all, the keeper of the knowledge produced as a result of its diverse activities and projects.

25 presentations were made, with an estimated total of 300 pages, on which I have been challenged to prepare a summary in order to embody their essential contents in this report. I understood that my contribution to this Assembly in my capacity as Rapporteur would be that of explaining the guiding principle among the different interventions and identify the complementarity relations; articulating the ideas set forth coming from differing perspectives and contexts; highlighting the elements that are in line and consistent with the topic in general and finally, drawing a number of general conclusions based on all the presentations and discussions. I will now move on to the report itself.

The general topic of the Assembly was divided into three thematic areas of presentations, as follows:

1. **Determination and estimation of potential collection. Analysis of the economic-tax potential and its conditioning factors.**
2. **The strategies for achieving potential collection.**
3. **International cooperation as a tool for achieving potential collection.**

The inaugural conference by Dr. José V. Sevilla Segura enlightened us on the general topic of the Assembly, in which he considered the traditional concepts of Strategic Planning as applicable to the public sector in the context of the Tax Administration. The speaker emphasized the following aspects:

- the need to identify and quantify the organization's ultimate objectives, defining a clear relation between these and the governmental policies applicable to the sector;
- the importance of following up and assessing said policies with a view to selecting the most effective ones;
- defining Potential Collection as a **reference variable** to set forth the objectives of Tax Administrations overall;

- the understanding that the mission of the Tax Administration is to succeed in the effort of having citizens meet their tax obligations correctly and, consequently, that the potential collection that is not realized constitutes the “fraud margin;”
- the importance for every Tax Administration to have a “map of fraud” indicating: the location of fraud; the profile of fraudsters; the most widely used means and instruments and, most importantly, the reasons leading persons to either meet or fail to meet their tax obligations;
- the analysis of the variables that determine taxpayer behavior is vital for developing strategies and policies aimed at improving the degree of compliance with tax obligations;
- the selection of the most suitable policies to counter fraud would result from the combination of two factors: the impact on the objectives pursued and the implementation cost.

On the basis of these premises, the speaker suggests three elements should guide the performance of tax administrations:

1. a map of fraud which sheds light on the magnitude and characteristics thereof;
2. an analysis of citizens’ tax behavior;
3. anti-fraud policies developed based on the previous two elements.

OBS.: The assessment of the efficacy of the different policies as feedback for the efforts to counter fraud.

The speaker also clarifies that the difficulties in quantifying fraud lie in their reference variable, that is to say, the estimation of potential collection, whose magnitude shall always remain an estimation. Therefore, he recommends different and supplementary techniques be used in the calculation. Likewise, the speaker mentioned the different perspectives of fraud and taxpayer behavior models, and then turned to the design and assessment of anti-fraud policies.

In his conclusions, Sevilla Segura repeated his main propositions in connection with the core theme of this Assembly:

1. fraud margins are the reference variable tax administrations should use to structure their objectives;
2. in measuring fraud margins, it is necessary to estimate potential collection in order to derive a “fraud x-ray;”

3. the fraud x-ray shall enable us to: (i) analyze the taxpayer behavior model and draft the applicable policies on this basis; (ii) estimate the impact each policy has had on its objective;
4. in order to assess the policies adopted by the TA, we must know both their impact and the costs - which include management costs as well as enforcement costs - borne by taxpayers.

Topic 1 - Determination and estimation of potential collection. Analysis of the economic-tax potential and its conditioning factors

The first speaker on topic 1 was Ms. Andréa Lemgruber Viol, from the Receita Federal of Brazil. She presented a conceptual framework that provided a structure for the reflections on this first thematic block. In addition, her presentation is inherently articulated with the presentations of thematic blocks 2 and 3, which is why I shall refer to her comments time and again with a view to better explaining the guiding principle behind the ideas discussed in this meeting. The "backbone" of sorts built by the Brazilian speaker shall be of great use in this Report in the sense that it shall shed light on the complementary and consistent nature of the different presentations and the core theme of the Assembly.

The speaker started her presentation by highlighting that in the great majority of countries taxation has been employed as the main source of State financing and, consequently, the size of the State is independent from the economic, social and institutional conditions of a country to collect taxes. That is the reason why the effective tax burden of a country is influenced by the collective decision of how much should be paid by way of taxes as well as the structural conditions of the country. Along the same lines as the inaugural conference, Andréa Lemgruber highlighted that the difference between the potential and effective collection attainable is explained by tax evasion. Therefore, every TA needs to manage risks and use its limited resources strategically in the strive to counter evasion and meet its tax potential.

The speaker advocates for the idea that tax administrations shall work with the concept of legal tax potential, understood as the "amount that would be collected should no taxpayer deliberately infringe the law and should, on the mean, involuntary errors add up to zero." She highlights that, in practice, the effective tax burden does not match the legal tax potential, especially owing to evasion and inefficacy of the tax administration. This difference between the restricted potential and the effective burden is defined as the

"tax gap." The speakers that follow shall frequently refer to the concept of tax gap. To this point, the speaker addressed the issues of effective burden, legal potential and structural potential, which lead to effective collection, "tax gap" and "potential gap."

The theoretical structure presented by Andréa Lemgruber is greatly relevant for purposes of tax policy and tax administration. It is essential for tax administrators to understand whether their countries operate with a potential gap or surplus when it comes to making important decisions, such as: changing rates, creating taxes, etc. On the other hand, it is important that they understand that a very great and protracted tax effort is only possible in high quality tax regimes with a fair distribution of the tax burden and, even so, with goals that are well accepted by society.

Along this line of thought, the efficacy of the tax administration shall be assessed based on its capacity to attain effective collection of the restricted (legal) potential, i.e., taking into account its capacity to minimize the tax gap. Stressing one of the assertions of the inaugural conference, the speaker defines the most relevant objective of a TA as "ensuring that all taxpayers effectively meet their tax obligations, as set forth by law." In summary, a TA should be judged mostly by its efficacy in the struggle against evasion and the fair enforcement of the tax regime on all taxpayers, rather than merely by collection performance.

Continuing with the issue, the author comments on the methodologies to estimate and analyze the collected revenues and the tax gap, identifying the four dimensions that a TA should explore upon analyzing the tax gap — instrumental, by type of tax, by sector and by region. Therefore, upon exploring the tax potential, data and analyses should be used that identify the prevailing types of evasion and the respective cost-benefit ratios to enable the definition of the most suitable strategy to reduce the tax gap.

Next, the speaker analyzed the relation between the tax potential and risk management, and explained the reasons why risk management should be used by the tax administration, in the understanding that said mechanism is: "a formal process whereby the risk factors of a specific context are identified, analyzed, measured, organized and solved systematically."

At the end of the presentation, the speaker listed the main advantages of a TA that focuses on reducing the tax gap:

- data and information analysis enables a better understanding of the TA context, thus perfecting the institutional intelligence or knowledge;

- since it is limited neither by a known mass of taxpayers nor by past performance, this type of TA may undertake new challenges, new fields of action and look into new – undertaxed – sectors;
- we must have every certainty regarding the risk universe before defining the strategy and/or instrument to be adopted, such as, for example: greater control or better services.

To summarize, the different risk situations entail specific strategies and tools to solve the specific issues of each TA.

She concludes by saying that this type of analysis is vital for TAs of developing countries, tasked with reducing the tax gap in the face of an external environment that is largely favorable to evasion and which have limited institutional and administrative capacity.

Four additional presentations were made within the first thematic block, grouped according to two topics:

1.1 **Projection, follow-up and analysis of the behavior of tax collection,** whose speakers were: José Antonio Salim from Argentina and Attilio Befera from Italy;

1.2 **The measurement and control of erosion of the tax bases (tax expense and tax evasion),** with the following presenters: Luiz Villela from the IDB and Ricardo Escobar from Chile.

In topic 1.1 – “Projection, follow-up and analysis of the behavior of tax collection,” the Argentine speaker started his presentation by asserting that resource estimation is a decisive instance in order to define and plan governmental tax policies, and emphasized the need for the Tax Administration to develop its own projections, regardless of whether other government offices undertake this task. Specific estimations developed by the TA will serve as support and enable a more efficient analysis of collection, which allows for its inclusion in the Tax Administration Management Plan. Said monitoring of the evolution of collection enables the identification of deviations from the projections with a view to enhancing the methodology employed.

Thereafter, the speaker presents the different methodologies used in making tax revenue projections, highlighting the advantages, disadvantages and implementation difficulties. He explains the direct method in further detail, which method was adopted by Argentina to draft collection projections. Said method considers the effects of changes in economic variables as well as regulatory and other types of changes affecting the tax base. This

methodology would span the following stages: (i) regularization of collection; (ii) tax projections; (iii) incorporation of the improvement percentage; (iv) inspection and control.

It was also clarified that projections comprise monthly, annual and triennial periods, and that they are followed on a daily basis by means of a control table designed for said purpose. The evolution of resources is analyzed monthly relative to internal and external data, broken down by item, economic activity and geographic location. Quarterly, said evolution is analyzed based on macroeconomic variables (GDP, consumption rate, etc.).

The speaker highlights that collection analysis and follow-up is key for planning and control purposes, in the sense that it allows the TA to improve the estimation methods employed and explain deviations, thus yielding the necessary input for decision-making and methodological improvement.

He concludes by emphasizing the need for tax administrations to rely on adequate planning of the tax resources required for compliance with the Governmental Tax Policy. He reiterates the same assertion made by previous speakers that the main objective of the tax administration is to secure tax revenue, which calls for resource planning in order to provide for the management of its different areas.

According to the speaker, the methods employed to draft projections require not only the use of statistic and econometric technical tools but also, and fundamentally, a genuine knowledge of tax regulations, the procedures to assess and collect taxes and the relations between collection and the economic aggregates and indicators that determine their evolution. In short: follow-up and analysis of the evolution of resources as compared with the projections defined make up a fundamental input for decision-making on tax policy and management of the organization.

The second presentation on topic 1.1 was made by the representative from Italy, who divided his approach into two areas: voluntary collection and enforced collection. Initially, the speaker presented on the deep changes which took place over the past ten years relative to legal organization and tax management. Thereafter, he reported on the main issues detected in the course of said process of organizational change, with a view to achieving greater tax collection efficacy.

Based on the analysis of the issues faced, a number of guidelines were defined for institutional changes and improvements, geared at the regularization and simplification of procedures. The speaker made a

retrospective reference to all the changes of a legal, administrative and procedural nature adopted with a view to improving voluntary compliance with tax obligations. Similarly, he analyzed enforced collection, especially regarding debt collection, assessment of installments, administrative review and assessment of tax debits. He also mentioned payment deferrals and executive and precautionary procedures relative to the protection and assessment of tax credits.

The speaker devotes special attention to the relation between the tax administration and collection entities, with the purpose of making the collection service more agile and efficient. He concludes his presentation by highlighting the legislative innovations linked to the enforced collection procedure.

As to topic 1.2 – “The measurement and control of the erosion of the tax bases (tax expense and tax evasion),” two presentations were made: one of a more conceptual and theoretical nature, by IDB representative, Luiz Villela, and another one with a more practical connotation, by the representative from Chile, Ricardo Escobar.

The IDB speaker began his presentation by pointing out that the main purpose of tax regimes should be collecting resources to finance government spending more efficiently, as well as ensuring a more equitable distribution of the tax burden. Thereafter, he discussed the issue of tax incentives, which are used for different policy purposes, such as promoting exports, attracting foreign investment, etc.

The speaker explained the notion of a tax incentive as a tax expenditure quite clearly, and reflected on the advantages and disadvantages as well as the main issues detected. He also presented a typology of incentives and the quantification methodology. The topic of tax incentives is quite controversial, since countless advantages as well as disadvantages have been associated with their use.

It was clarified that refunds of excise taxes paid in the stages prior to exports are no longer deemed applicable, given the general consensus in the sense that taxes cannot be exported. Likewise, he stated the reasons that justify the use of regional, sectorial, R&D (technology transfer) incentives and tax credit modalities. A distinction was made between tax incentives and tax benefits.

The second part of the presentation refers to the so-called tax expenditures, meaning the government spending made through the tax regime instead of directly from the budget. This way of looking at tax benefits is an innovation, according to the speaker, and it represents a kind of departure from the tax regulatory structure, even seeking to serve non-tax governmental objectives. Tax expenditures may arise from exclusions, exemptions, deductions, credits, preferred rates and deferment of tax obligation assessment.

The speaker devoted a significant part of his work to the difficulties inherent in the assessment of tax expenditures, as well as the analysis of the advantages and disadvantages of the use thereof. In this regard, he analyzed several situations, mentioning which could be normally included in the normative structure of the tax, and distinguishing them from those that would make up tax expenditures by virtue of being a deviation from said normative structure. Thereafter, a number of methodologies were presented to estimate and quantify tax expenditures, including: (i) collection losses; (ii) expenditure-equivalent or budgetary expenditure; (iii) analysis of historic series within the same country.

The main advantages pointed out by the speaker regarding tax expenditures were: (i) participation of the private sector in welfare and economic programs; (ii) promotion of the private decision process (initiatives and choices); (iii) reduced need for the government to participate in certain government spending programs. As to the negative aspects of tax expenditures, these are generally related to inefficiency and inefficacy, representing open government spending in practice, which conceals the real size of the State. One of the most serious effects of tax expenditures would be the erosion of tax bases, with possible tax increases for those who do not benefit from the effects thereof.

The recommendation was made to draft tax expenditure reports or budgets for purposes of fiscal transparency, as well as to ensure an efficient distribution of government resources and estimate potential collection losses. The author concludes with an analysis of tax expenditures in the United States of America, based on a recent study by the Government Accountability Office (US GAO) of 2005.

During the second presentation of this section, the speaker, Ricardo Escobar from Chile, revisited a number of notions presented earlier by Andréa Lemgruber, mostly as to the measurement of potential collection and collection capacity. He treats the measurement of tax expenditure and tax evasion separately.

The presentation is based on Chile's experience regarding these topics. We must highlight that as of 2002, the estimation became part of the Public Finance Report, which is attached to the General Federal Budget Act.

Then, the speaker presented the methodological aspects in measuring tax expenditures, which use an *ex post* measurement, based on the actual information of a past period and assume a taxpayer change of behavior (total ongoing expenditure). They further use a cash flow evaluation analogous to the one employed in drafting the budget. The author listed the main sources of information used for estimations (returns, fiscal statistics, national accounts, other public information presented in corporations' financial statements, etc). He also mentioned the main methodologies employed, highlighting the following: Income Tax simulations, projections to the total universe based on the simulations performed, estimations based on aggregate data or tax collection statistics data. In the case of VAT exemptions, the estimations are also based on data provided by the input-output matrix.

Tax evasion estimations were performed at the beginning of the nineties, using the theoretical potential method, based on the National Accounts. At the same time, alternative methods were developed, mainly to measure VAT and Income Tax evasion. The author describes the main methods employed to measure tax evasion, indicating the specificities thereof. The main methods analyzed were: (i) Theoretical Potential based on National Accounts; (ii) VAT evasion indicator, based on the Productivity-End Consumption Index; (iii) Potential Collection based on household budget surveys or other similar ones; (iv) VAT evasion, using point audits with random sampling; (v) VAT evasion, based on false invoices, verified by crossing/reconciling tax information.

Topic 2 – The strategies for achieving potential collection.

The Canadian representative, Guy Proulx, was in charge of the first presentation of topic 2, which deals with the strategies to achieve potential collection. The speaker highlights that in the current business environment, organizations are in a permanent quest for alternatives that enable them to become more effective. Therefore, they look to forms of responding to the new and growing demands for public sector services with the resulting increased need for resources. These challenges are also applicable to tax administrations, whose key efficiency measure is based on the way they face the tax collection gap, that is to say, how they treat the difference between what they could potentially collect and what is effectively collected from the strategic and management standpoint.

The speaker presents the Canadian experience, in the sense of improving their operations, with a view to overcoming the challenges posed to them. In this regard, the TSDMB (Taxpayer Services and Debt Management Branch) adopted a number of provisions to enhance organizational efficacy. They worked with workloads and workflow processes, seeking to involve taxpayers earlier in the collection cycle. Risk management strategies were also introduced, with a view to handling workloads more strategically by eliminating geographic barriers to attain a better use of limited resources.

The speaker points out that in spite of the improvements made, the organizational environment is still evolving, being permanently faced with new challenges. The main issues currently facing the TA are: (i) the growth and aging of the tax collection portfolio; (ii) the need for technological update; (iii) the commitment towards expanding the core business; (iv) the development of solutions relative to tax policies.

With the purpose of maximizing the potential to generate tax income, the institution's business methods shall continue to be perfected. Great progress has been achieved as to business transformation measures by a better use of technology, professional employee performance and business processes. What is pursued at the end of the organizational transformation agenda is to have the appropriate work delivered to the correct person at the right time. This shall be achieved by handling tax collection issues together with those relative to taxpayers' compliance on a global and not segmented basis, by conducting solid and consistent analyses, defining flexible business rules and a strategic risk management methodology.

One of the key events in the transformation process is worth highlighting: in 1994, the Office of the Auditor General – OAG, submitted a report that recommended measures to improve tax collection activities. Another issue to highlight was the creation of the National Collections Call Centre, in 1997, which involved taxpayers earlier in the collection cycle. At that time, the Revenue Enforcement Management and Tracking System was created, which put together risk profiles for debtors. On the other hand, innovative mechanisms were adopted to transform debt management activities.

In the speaker's view, the outcomes pursued are difficult, yet not impossible, to attain. They shall arise along the process and be beneficial in future organizational transformation and improvement activities.

Within thematic block 2, six additional presentations were made, grouped into three topics:

- **2.1 Administrative innovation as a way to secure tax resources,** with the following speakers: Laurent Amairic from France and Hans van der Vlist from The Netherlands;
- **2.2 Compliance control,** with the following speakers: Marta Guelbenzu Robles from Spain and Juan Hernández from the Dominican Republic;
- **2.3 The importance of legislative changes to reduce tax evasion and avoidance,** featuring the following speakers: Sabina Walcott-Denny from Barbados and Jorge Rachid from Brazil.

Regarding topic 2.1 – "Administrative innovation as a way to secure tax resources," the speaker from France highlighted the institutional commitment of making progress in two aspects: the relation with taxpayers-users and the improvement of tax collection. The improvement of the services rendered to taxpayers-users entails the adoption of new technologies and the creation of a "one-stop shopping" system for tax formalities. Simplifying tax obligations for the taxpayer-user favors the development of a fiscal awareness that, together with strict control measures, contributes to improve tax collection.

The speaker highlighted the main items of the structural reform of the tax administration relative to the first issue, namely: to develop a relationship with taxpayers-users. To this end, the structures of the tax administration that deal with large corporations as well as those in charge of small enterprises are focused on the concerns of taxpayers-users, with specific services and interlocutors: the Corporations Directorate (DGE as per the French acronym) and the SIE (Corporate Tax Service as per the French acronym). Likewise, individuals may complete tax formalities in a single tax office, thanks to the creation of financial delegations, called "*Hotel de Finances*".

This focus on the administration-user interface shall not conceal another concern of the Internal Revenue Agency (DGI, as per the French acronym), namely the effort to counter tax fraud.

As to the second issue, the work presented underlined the creation of the Regional Intervention Groups (GIR, as per the French acronym), which work jointly with the Customs Office and Police forces employing effective methods to counter financial crimes and the underground economy.

He concludes by underscoring that the pillars for structural reforms consist of a set of tools to streamline tax administration with a focus on restructuring its information system. Said restructuring shall bring about facilities for the taxpayer-user, like the creation of a single tax account and an option for the taxpayer to choose from a menu of different communication channels vis-à-vis the administration: telephone, Internet, mail. Additionally, web-based facilities are provided to file tax returns and make tax payments electronically.

He emphasizes, once again, the need for said innovations to be subject to strict controls to ensure their true efficacy based on management controls and performance indicators. He also points out the relevance of monitoring the behavior of tax collection over a given period.

Also regarding topic 2.1, the representative from The Netherlands highlighted the following issues in his presentation:

- administrative innovation processes are based on the rapid pace of social changes and the fact that the internal systems and processes of the tax administration are outdated, in addition to being costly and inflexible;
- he offers a diagnosis of the main issues detected in the tax administration that shall guide institutional modernization efforts;
- the analysis of the TA business potential shall serve as a guideline for planning and institutional changes;
- defining administrative modernization budgets, and the concern over the institutional acceptance of the process;
- creating a multidisciplinary group to lead the change process;
- defining a number of short-term exemplary strategies to help promote the process;
- creating two different modalities of action: (i) a softer approach, geared at servicing taxpayers who fail to meet their tax obligations for the first time; (ii) a more coercive approach, for high risk taxpayers who fail to meet their tax obligations;
- the relevance of having potential collection as a “backdrop” to the business architecture;
- the need for more effective legal and regulatory provisions to support administrative collection actions and protect tax credit, with a broad scope that includes intervention on taxpayers property and even their bank accounts;
- in the struggle against fraud, an extensive legislation that serves to support the most effective measures, with the reversal of the burden of the proof in order to favor the work of the tax administration. In

practice, this legislation on fraud liability has a predominantly preventive effect.

As to topic 2.2 – Compliance control, speakers Marta Guelbenzu Robles from Spain and Juan Hernández from the Dominican Republic highlighted the following aspects:

a) Issues highlighted by the Spanish speaker:

- The tax administration shall undertake efforts to favor compliance by tax administrations in all tax areas, thus countering intentional noncompliance.
- Modern administrations shall avail themselves of strong control mechanisms, the effectiveness of which depends inherently on the system's credibility.
- The TA shall be prepared to face the reluctance of less cooperative social groups, as well as that of the sectors that rely on sophisticated means to achieve their fraudulent purposes.
- Tax Planning strategies deserve special attention, since they frequently border on evasion and fraud based on financial projects designed by Tax Law experts.
- Modern tax policy shall be in line with two approaches: (i) improving risk analysis instruments to correctly identify fraud locations and (ii) fostering immediate control with a view to responding promptly vis-à-vis tax avoidance and tax evasion strategies.
- A comprehensive approach seems to be the fittest path to counter fraud, with cooperation from the different government agencies competent, both national and international, which should be involved in identifying and repressing fraud.
- The presentation further provides a detailed analysis of the legal fundamentals and the strategies adopted by the Spanish tax administration in controlling taxpayer compliance.
- The Spanish presentation makes relevant contributions by discussing the Planning Strategies and Procedures adopted to combat fraud as well as the Tax Fraud Prevention Plan.
- Equally relevant are the reflections and comments contained in the AEAT (Spanish Government Tax Administration Agency, as per the Spanish acronym) Proposals regarding international fraud mechanisms and in the item that deals with international cooperation as an instrument to prevent and counter tax fraud.

b) Issues highlighted in the presentation by the Dominican Republic:

- Compliance control is an essential area for any Tax Administration. The greatest difficulty in analyzing it lies in the diversity of approaches that may exist depending on the degree of maturity of a society, the levels of voluntary compliance and the features of the applicable tax regime, among others.
- All countries require a policy for compliance control that encourages voluntary compliance and, on the other hand, reduces the possibilities for tax evasion, avoidance and fraud.
- In countries with a low level of voluntary compliance, efforts should focus on changing the tax culture, by making decisions that impact large groups and have multiplying effects. The aim should be to increase the perception of risk by the taxpayer who fails to meet his/her obligations as well as by fraudsters.
- The paper also provides an important reflection on: (i) the mission of tax administrations and the way in which they bear a relation with the purpose of improving compliance levels; (ii) the principle of fairness and the relation with compliance control processes; (iii) promoting voluntary compliance; (iv) the importance of technology as a means to exercise control powers.
- The presentation explains the experience of the Dominican Republic relative to the topics indicated in the previous paragraph and, finally, it presents a case study of control measures in countries with low compliance levels.

In topic 2.3 – The importance of legislative changes to reduce tax evasion and avoidance, the speaker from Barbados, Sabina Walcott-Denny, emphasized the following aspects:

- She reiterated the assertions by preceding speakers that the key role of a tax administration is efficient tax collection;
- Modern collection methods should be used along with an enforcement structure that is expeditious, pertinent and results-oriented;
- Taxpayers, on the other hand, seek to minimize their tax obligations, resorting to both lawful and unlawful means;
- The tax administration employs changes in legislation as a resource to meet its institutional mandate and reduce tax evasion and avoidance;

- Next, the speaker presented the main steps to promote changes in legislation, chiefly as a way of preventing tax avoidance and evasion;
- The paper presents an analytical description of Barbados' experience in areas and activities that used legislative changes as a measure to reduce tax evasion and avoidance. Specifically: the tax system of corporations and natural persons; the new tax regime of excise tax – VAT, as well as the use of administrative tools (source withholdings, access to bank accounts, attachments);
- She concludes her presentation by asserting that legislative changes shall always be a useful tool to face the mentioned challenges and maximize potential collection of tax revenue.

Still on topic 2.3, which analyzes the relevance of legislative changes, the representative from Brazil, Secretary Jorge Rachid, made a very informative presentation in which he described and analyzed the fundamentals and outcomes of numerous measures to counter tax evasion and avoidance, which were supported by legislative changes. Hereunder, I shall attempt to summarize the analysis and comments on the key legislative changes presented by the Brazilian speaker:

- Many proposals seek to either reduce or eliminate legal gaps or make adjustments with the purpose of improving control over taxpayers' transactions, reduce the risk of the existence of tax evaders, and minimize the opportunities for those who plan lower than due payments and tax deferrals.
- The tax administration shall play an active and central role in supporting the drafting of tax legislation and enhancing the legal and regulatory structure on tax matters.
- The paper first describes the Brazilian macroeconomic context in order to understand the reasons that led to legislative measures to counter avoidance and evasion, already described and analyzed in the third section.
- Legislative changes were grouped as follows: (a) changes geared at bridging legal gaps; (b) changes geared at contributing to taxpayers' control and monitoring; (c) measures for information exchange and cooperation; (d) other legislative measures of a general nature that bear an impact on tax evasion.
- Among the changes geared at overcoming legal gaps, we may highlight: taxation on universal bases; transfer pricing legislation; legislation on tax havens.

- Among the changes geared at assisting in the control and monitoring of taxpayers, we may underline: the source withholdings system; the adoption of single-phase tax regimes; the adoption of specific taxes for specific products (*ad rem* tax rate); flow meters in the beverage industry; a control and follow-up system in cigarette production; oversight and bank secrecy; Report on Credit Card Transactions- DECRED and the Informative Return on Real Estate Transactions – DIMOB; the mandatory registration in the CNPJ and CPF for foreign corporations and individuals, respectively.
- Among the information exchange and cooperation measures, we may highlight: the exchange of information between and among federal and state revenue offices; the implementation of the synchronized registry.
- Among the remaining legislative measures of a general nature with an impact on tax evasion, the following may be underlined: Provisional Contribution on Financial Transactions-CPMF and the Integration with Social Security Revenue.
- He concludes by highlighting that, in the last few years, the Brazilian experience has been marked by numerous legislative changes resulting in a reduction of tax evasion and avoidance, which additionally contributed to improve the efficacy of the Tax Administration. The author points out that none of these changes would have been possible had the Receita Federal failed to participate in government decisions. Likewise, the fact of being a highly reputable and credible institution has enabled the Receita Federal to formalize internal covenants and protocols on cooperation and exchange of information with other government entities.

In the course of the third day, Wednesday April 5th, two very relevant presentations were made on the main theme of the Assembly, Potential collection as goal of the tax administration. I am referring to the presentations by the CIAT working groups devoted respectively to the topics of Internal Control and Tax Intelligence as an instrument for control actions, with the presentation of two CIAT Manuals as one of the outcomes of the working groups' efforts.

The presentation on the first issue was made by Spain and Argentina. They highlighted the relevant role that the CIAT has been playing in the area of Internal Control and Audits in tax administrations. They described the composition of the working groups and provided a retrospective overview of their work leading to the presentation of the CIAT Internal

Audit Manual, the contents of which were the gist of the presentation. A relevant correlation is made between Internal Control and Risk Management in Tax Administrations, which refers to the main theme of the Assembly – potential collection. Next, the presentation makes reference to internal audit topics per se, covering conceptual, organizational, procedural and administrative approaches, in addition to setting forth certain principles and technical guidelines for audits to be applied in tax administrations.

Gerson Schaan from Brazil presented the second topic relative to Tax Intelligence. It basically consisted of the presentation of the CIAT Tax Intelligence Manual, whose contributions I summarize hereunder:

- The challenges vis-à-vis compliance control have led to great efforts by tax administrations in the XXI Century, mainly due to the growing availability of an environment that fosters the perpetration of tax fraud, avoidance and evasion.
- The presence of organizations that, based on their *modus operandi*, could be qualified as criminal for fostering tax crimes.
- The paper summarizes the main features of these organizations, in addition to describing the context in which they develop their activities and the hurdles they raise for tax administrations.
- Thereafter, a retrospective overview is given on the activities of the working group and the Manual's objectives are described. The speaker further defines Tax Intelligence and mentions some of the topics of special interest discussed.
- Finally, several recommendations on tax intelligence activities by tax administrations were presented.

Topic 3 - International cooperation as a tool for achieving potential collection.

The first presentation of this third and last thematic block was made by the United States representative, Deborah Nolan, who emphasized the following aspects:

- Since potential collection is a dynamic variable, it depends on other variables present in the internal as well as the international environment of the country in which the tax administration operates.
- Globalization and the growing economic integration should produce administrative strategies with a view to enhancing collection of tax obligations, paying special attention to the international environment.

- The improvement of the institutional relation with other tax and government authorities is an undoubtedly beneficial resource for collection efficacy.
- The speaker analyses a number of initiatives of the American tax administration regarding potential collection and identifies the need for international cooperation as a key component in the efforts undertaken by the United States vis-à-vis this issue.
- In the speaker's view, international cooperation is a *sine qua non* condition for effective tax administration.
- Cross-border tax transactions deserve special attention, with a view to ensuring that international transactions comply with current tax legislation.
- Likewise, international transactions and globalization of tax affairs call for special consideration. The IRS identified a number of avoidance schemes involving currency, offshore tax havens and the use of banks outside the USA to avoid filing income tax.
- The speaker highlights the two relevant and specific areas for international cooperation that are discussed in this same thematic block of the Assembly: exchange of information and harmful tax practices.
- In her presentation, she describes and analyzes the relevance of International Forums, Multilateral Exchanges and Horizontal Technical Assistance, and states the main initiatives of these international cooperation modalities in which the USA has been involved.
- The United States experience regarding these issues and initiatives is repeatedly highlighted during the presentation as a way of providing a context for the theoretical approach and offering more up-to-date comments and reflections.

Within thematic block 3, four additional presentations were made, grouped into two topics:

3.1 The exchange of information and assistance for securing and executing tax debts, featuring speakers representing the OECD and Portugal.

3.2 The struggle against harmful tax practices: joint actions and unilateral measures, featuring the following speakers: Clotilde Palma – ISCAL- Portugal and Enrico Martino from Italy.

Regarding topic 3.1, the two speakers highlighted the following aspects:

a) OECD representative:

- Description of the bilateral and multilateral mechanisms for information exchange and assistance regarding tax collection, indicating the way in which they may contribute to a greater efficacy of tax administrations.
- The review of Article 26 of the OECD Model Convention on Information Exchange was especially highlighted as well as the efforts by the OECD as to offshore financial centers.
- The second part of the paper offers a brief summary of the review of tax collection strategies and approaches, with the purpose of addressing the concerns of a number of OECD-member countries regarding the increasing incidence of noncompliance with tax obligations.
- The presentation also discussed the following aspects: (i) the growing importance of information exchange and mutual assistance in tax collection matters; (ii) the international legal framework; (iii) forms of information exchange; (iv) basic international information exchange rules; (v) basic rules for international mutual assistance in tax collection matters; (vi) recent OECD initiatives.
- Regarding the administration of tax debt collection activities, the author underscored a number of general guidelines for the research framework on countries' tax debt collection practices, as well as the main findings and conclusions of the research.

b) Representative from Portugal:

- She highlighted the relevance of international tax oversight for the effectiveness of tax systems, both in terms of standards design and the streamlining of tax administration operations.
- Currently, tax administrations are faced with harmful tax competition, stemming from the existence of countries or territories that adopt policies of null taxation or very low taxation.
- Today, decisions and business may be moved to the most advantageous locations worldwide in taxation and economic terms.
- The erosion of tax revenue in the avoided countries is one of the outcomes of such harmful tax competition, which entails a distortion of trade flows and bears consequences on the taxation of resources worldwide.

- The internal measures adopted by countries to face said harmful competition have not yielded the expected results.
- Serious attention has been paid to the inter-state, bilateral or multilateral cooperation mechanisms that essentially include exchange of information and assistance in the collection of tax credits.
- Next, the speaker refers to a number of experiences in Portugal in the area of international cooperation and analyzes the core benefits, setbacks and issues, as well as the feasibility mechanisms adopted.
- According to this approach, the presentation discussed the issue of exchange of tax information, the roles and legal instruments thereof and the specific types and cases.
- Then, reference was made to administrative cooperation in Portugal, with an analysis of the underlying legislative instruments thereof, the responsible institutions and quantitative data in that regard.

As to topic 3.2, the representative from Iscal of Portugal analyzes the issue of harmful tax competition based on the approach adopted by the European Union and the OECD. Specifically, reference is made to the most relevant unilateral measures adopted by Portugal in order to face harmful tax competition, specifically those that were conceived with a view to avoiding the abusive use of the so-called “clearly more favorable” tax regimes.

In her views with regards to international fraud and tax evasion and the use of low taxation regimes, the author discusses the new approach in the efforts to counter harmful tax competition and presents the Tax Code on Corporate Income. In terms of the most relevant measures to control harmful tax competition adopted by Portugal, the speaker presents the corrections for the cases in which special relations exist; transfer pricing corrections; thin capitalization rules; non-acceptance of cost treatment; taxation of capital gains and capital losses; elimination of double-taxation on distributed earnings, among other aspects.

The initiative to define what “clearly more favorable tax regime” should be understood to mean deserves special consideration, as should the general anti-abuse provision and access to banking information and documentation.

She finishes her address with the analysis of two concrete situations: the changes in the tax regime of the Duty Free Zone of Madeira and the creation of a new anti-abuse measure in the Tax Code on Corporate Income, in response to the issue of the abusive use of preferential tax regimes.

The second speaker in topic 3.2, who presented the Italian experience relative to this issue, emphasized the following aspects:

- The right avenue to counter harmful tax practices is, undoubtedly, that of international cooperation, with a view to increasingly undertaking information exchange efforts as a fundamental tool for tax administrations to meet the efficacy pursued.
- Therefore, CIAT represents a favorable institutional space to foster and stimulate said information exchange, as are the OECD, the European Union and others that have already started to adopt this practice.
- The speaker reports on the European Union and OECD experiences in this regard, as a possible source from which principles, guidelines and cooperation models may be drawn.
- Afterwards, he analyses the information exchange situation in Italy and considers a number of difficulties encountered and the measures adopted to overcome them.
- He concludes his presentation by highlighting the fact that certainty, fairness, efficiency and transparency are assumptions that should be respected at all times vis-à-vis tax matters under the Rule of Law. Secondly, the actions of individual, bilateral or collective nature are the necessary instruments to meet an adequate level of transparency and information exchange in tax matters with a view to securing a fair and healthy degree of competition among tax regimes.

CONCLUSIONS ON THE RAPPORTERUR'S GENERAL REPORT

Main trends for tax administrations in the XXI Century:

a) Most presentations showed the use of notions pertaining to the area of Strategic Planning and Results-based Government Management in Tax Administration. The adjustments made to said concepts for the tax area entail a relevant effort to provide a context, which is much more useful than the simple linear transposition thereof.
b) Potential Collection and Fraud Margins make up the reference variable for Tax Administrations and play a relevant role in building scenarios, defining budgets and objectives on tax matters.

c) The relevance of the notion and methodology of Risk Management applied to the tax administration is highlighted, which calls for the analysis of the political and economic context, based on the identification of issues and the analysis of their causes as guidelines for tax administration planning efforts.
d) Another relevant trend is the assessment of the impact and effectiveness of the actions planned by tax administrations on the respective countries' societies.
e) The same applies to the monitoring efforts undertaken on the basis of result and impact indicators, instead of product and process indicators, as was the case in the past.
f) The strategic components of tax administrations are no longer focused on a self-reference model, with an inherent end, but have broadened their scope to the limits of their governance and work according to the restricted concept of potential collection, which is set forth on the basis of the legislation in force.
g) The reference framework, the most relevant and guiding goal for tax administrations, is potential collection in the restricted sense, as the majority of the speakers acknowledged.
h) There was an almost unanimous consensus as to the need to balance two trends in the actions of tax administrations: a softer approach and a more stringent one based on enforcement and coercion. The former is geared at education efforts; the promotion of civic awareness; the provision of services to the citizen-taxpayer. The latter is more focused on the reduction of the risk of noncompliance with tax obligations, as well as the analysis of the cost-benefit ratio as a means to discourage and reduce the economic advantage for citizens who wish to infringe their tax obligations.
i) Many of the presentations made reference to the fact that tax legislation broadened, and to a certain extent recovered, its role of facilitator of the efficacy and effectiveness of the tax administration. Tax legislation was presented not only as the basis for tax systems and tax policies, but also as having a coercive and instrumental role. Tax legislation was discussed in this Assembly, reinforcing the inherent function of the right to regulate behavior and relations among men in society, as one of the prerogatives of the Rule of Law. In the context of many of the presentations, tax legislation was deemed an instrument to enable the efficiency and efficacy of tax administration.

j) Finally, presentations strongly stressed inter-institutional and international cooperation, reinforcing the role of spaces for institutional integration. I conclude my summary by revisiting the idea set forth in the beginning of this Report: that CIAT is an asset of tax administrations by virtue of its uniting and harmonizing role as to tax behaviors and procedures, for its privileged devotion to creating knowledge networks, promoting exchange of information, ideas and good practices and for producing and disseminating specialized technical knowledge on tax matters.

Once again, I extend my deep gratitude to the Receita Federal and CIAT, for their invitation and for the valuable learning opportunity that this 40th CIAT Assembly has been to me.

RESOLUTION OF THE 40th CIAT GENERAL ASSEMBLY
“POTENTIAL COLLECTION AS GOAL OF
THE TAX ADMINISTRATION”

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Whereas:

The increased effectiveness of a tax administration may be measured in terms of how actual collection approximates the amount of potential collection;

It is important that in order to promote collection and achieve such approximation as its management goal, TAs determine and implement strategies based on administrative innovation, on the use of technological advances, on control and facilitation measures and that even, within their competencies, they promote the adaptation of the rules that govern taxes and their legal action framework;

Potential collection, in addition to being a dynamic variable, is not restricted to the country's internal environment, while the globalization of the economy also conditions the tax administration's strategies for effectively carrying out its functions and, in particular, for achieving potential collection;

Tax administrations are faced with the difficult challenge of controlling international tax planning which commonly makes use of the so-called "tax havens," established for attracting and providing refuge to significant financial resources by promoting tax evasion in other countries, which results in reduced collection in the latter;

Cooperation among tax administrations is necessary in order to avoid the action of a national administration from being confined to its territorial limits and that in addition, joint actions may be promoted in areas of common interest for combating tax fraud and evasion.

The General Assembly,

RESOLVES:

To recommend that the tax administrations of its member countries:

FIRST: consider Potential Collection as a goal to be pursued for effectively fulfilling their mission, to which end it is convenient to:

1. to develop and apply methodologies for projecting total tax revenues of a specific period, by type of tax, by area of economic activity, by type of taxpayers, by geographic regions and by economic sectors;

2. measure and control the so-called "tax expenses" and present them to society in a disaggregated manner, for identifying the beneficiaries, thus affording transparency to the effective sectorial, regional and social distribution of the tax burden; and

3. implement methods for identifying and measuring or estimating tax evasion that may allow for evaluating the effectiveness of the TAs control of the different taxes and orienting corrective actions toward making them more effective.

SECOND: should undertake internal analyses of the weaknesses and strengths of their organizations, as well as the opportunities and challenges existing in the external environment; in addition to actions for strengthening the "subjective risk" vis-à-vis noncompliance, for which purpose it is convenient to:

1. promote administrative innovation and the improvement of the operational structure, as well as the development and evaluation of the tax processes, which are essential elements for achieving potential collection;

2. focus examination actions on those of greater effectiveness, by using risk analysis techniques and proactive actions in controlling specific entrepreneurial activities; as well as concentrating efforts in detecting and analyzing juridical and commercial structures used for tax fraud, evasion and/or avoidance;

3. propose changes in legislation that may allow for reducing tax evasion and avoidance, better use of the bases of incidence and the development of equity and neutrality of the tax system.

THIRD: should endeavor to adopt cooperation mechanisms among the TAs and contribute to identify possible solutions for the new challenges originating from the internationalization of the economy, for which purpose it is convenient to:

1. promote the adoption of specific agreements for the exchange of information and for contributing to strengthen and collect tax debts abroad;

2. prioritize the struggle against the schemes used by international tax evasion, through the adoption of joint and unilateral actions that may endeavor to neutralize the effects of harmful tax competition.

TECHNICAL PROGRAM

40th CIAT GENERAL ASSEMBLY
Florianopolis, Santa Catarina, Brazil
3-6 April, 2006

DAILY SCHEDULE OF ACTIVITIES

Monday, April 3

MAIN THEME: **POTENTIAL COLLECTION AS A GOAL OF THE TAX ADMINISTRATION**

Morning

09:00 – 10:00	Inaugural ceremony
	Moderator: EC President, Argentina
10:00 – 11:00	**Inaugural Conference:** **Potential Collection as a Goal of the Tax Administration.**
	Speaker: José Víctor Sevilla Segura, CIAT Consultant.
	Open discussion
11:00 – 11:20	Official photograph
11:20 – 11:40	Recess
	Topic 1. Determination and Estimation of the Potential Collection. Analysis of the Economic-Tax Potential and its Conditioning Factors.
11:40 – 12:20	**Speaker:** Andréa Lemgruber, General Coordinator of Tax Policy, SRF – Brazil.
12:20 – 12:50	**Commentators:** IMF and Peru.
12:50 – 13:20	Open discussion

Afternoon

Topic 1.1. Projection, follow-up and analysis of the behavior of tax collection.

Moderator: Venezuela

14:30 – 15:30 **Speakers:** José Antonio Salim, Studies Director, AFIP - Argentine, Attilio Befera/Rafaelle Marra, Central General Management Department Director, Revenue Agency, Italy.

15:30 – 16:00 Open discussion

16:00 – 16:30 Recess

Topic 1.2. Measurement and control of erosion of the tax bases (tax expenses and tax evasion).

Moderator: Colombia

16:30 – 17:30 **Speakers:** Luiz Villela, Tax Specialist – Economist, IDB and Ricardo Escobar Calderón, General Director, SII - Chile.

17:30 – 18:00 Open discussion

Tuesday, April 4

Morning

Topic 2. The strategies for achieving potential collection.

Moderator: USA

09:00 – 09:40 **Speaker:** Cathy Gibson / Guy Proulx, Taxpayer Services and Debt Management Branch, CRA – Canada**.**

09:40 – 10:10 **Commentators:** Mexico and CIAT.

10:10 – 10:40 Open discussion

10:40 – 11:10 Recess

Topic 2.1. Administrative innovation as a way of guaranteeing tax resources.

Moderator: Uruguay

11:10 – 12:10 **Speakers:** Jean Pierre Lieb, Deputy Director of Tax Legislation, DGI - France and Hans van der Vlist / Peter Jongkind, General Deputy Director, Dutch Tax and Customs Administration, The Netherlands.

12:10 – 12:40 Open discussion

Afternoon

Topic 2.2. The control of compliance.

Moderator: Guatemala

14:00 – 15:00 **Speakers:** Luis Pedroche y Rojo / Carlos Herrera Álvarez, General Director, AEAT - Spain and Juan Hernández Batista, General Director, DGII - Dominican Republic.

15:00 – 15:30 Open discussion

15:30 – 16:00 Recess

Topic 2.3 The importance of legislative changes to reduce tax evasion and avoidance.

Moderator: Trinidad & Tobago

16:00 – 17:00 **Speakers:** Sabina Walcott-Denny, Commissioner of Inland Revenue, Barbados and Jorge Antonio Deher Rachid, Secretary, SRF – Brazil.

17:00 – 17:30 Open discussion

Wednesday, April 5

Morning

Moderator: Ecuador

09: 00 – 09:20 **Internal Control – Presentation of the CIAT Manual developed by the Working Group on Internal Control: Spain and Argentina.**

09: 20 – 09:50 Open discussion, comments and suggestions.

09:50 – 10:10 **Tax intelligence as instrument for control actions. Presentation of the CIAT Manual developed by the Working Group on Tax Intelligence: Brazil.**

10:10 – 10:40 Open discussion, comments and suggestions

10:40 –12:30 **Administrative Session for members only**

Afternoon

FREE

Thursday, April 6

Morning

Topic 3. **International Cooperation as Tool for Achieving Potential Collection**.

Moderator: Paraguay

09:00 – 09:40 **Speaker:** Deborah M. Nolan, Commissioner, Large and Mid-Size Business Division, IRS - United States of America.

09:40 – 10:10 **Commentators:** Costa Rica & South Africa.

10:10 – 10:40 Open discussion

10:40 – 11:10 Recess

Topic 3.1. The exchange of information and assistance for securing and executing tax debts.

Moderator: Jamaica.

11:10 – 12:10 **Speakers:** Matthijs Alink, Senior Advisor - OECD and António Magalhaes Machado, Deputy Director, DGCI - Portugal.

12:10 – 12:40 Open discussion

Afternoon

Topic 3.2. The struggle against harmful tax practices. Joint actions and unilateral measures.

Moderator: IDB.

14:00 – 15:00 **Speakers:** Clotilde Celorico Palma, Professor – ISCAL and Enrico Martino, International Relations Office Director, Ministry of Economy and Finance – Italy.

15:00 – 15:30 Open discussion

15:30 – 16:00 Recess

16:00 – 16:30 **General Report -** Maria de Fátima Pessoa de Mello Cartaxo, Sectorial Specialist, Inter-American Development Bank – IDB.

16:30 **–** 17:30 **Closing ceremony**

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Santa Catarina, Brazil
April 3 - 6, 2006

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