South African
Revenue Service

CIAT Technical Conference

Topics Emerging from the Agenda of the Tax Administrations

Johannesburg, South Africa
September 29 to October 02, 2008

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South African Revenue Service – SARS

CIAT TECHNICAL CONFERENCE

TOPICS EMERGING FROM THE AGENDA OF THE 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 38 countries: 29 countries from the Americas and 5 European countries as full members, and 4 countries as Associate Members: Czech Republic, India, Kenya and South Africa. 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

Dr. Claudino Pita

Mr. Pravin Gordham, Commissioner, South African Revenue Service, Mrs. President of CIAT Executive Council and other Representatives and officials that form part of the delegations of CIAT member countries and other tax administrations present, officials from national and international organizations accompanying us. First, I wish to thank you for accepting our invitation to participate at CIAT's Technical Conference.

At the same time we wish to make evident our profound appreciation for the authorities of South Africa, who has made possible the holding of this Conference in Johannesburg and who together with the officials of your tax administration cordially, receive us as friends in your great country.

Here we have clear evidence of South Africa's adherence to CIAT's essential objective: promote mutual collaboration between our administrations, strengthening friendship ties and generous cooperation among all our member countries.

For its member countries CIAT is structure support, that is product of the joint effort among organizations that recognize each other as similar in regards to the purposes and the challenges to be faced, which allows them to have references to support improvement processes by sharing experiences and the joint analysis of experiences that CIAT promotes at meetings such as this one.

Also, the gathering and meeting the officials of the tax administrations of the different countries, who share concerns on similar problems, fosters opportunities to acquire firsthand knowledge of alternatives and offer or request support to solve the same, and CIAT promotes and coordinates actions of this nature.

CIAT is among the organizations that internationally have always been at the vanguard in the analysis of current and priority interest issues for the tax administrations.

This time, the program to be developed at this Technical Conference will allow the analysis and sharing of experiences on "**Topics Emerging from the Agenda of the Tax Administrations,"** this means to center our discussions on issues that, if not all are new, the changing environment where our tax administrations are framed, grant them impact and the degree of importance to justify our reflection and attention.

Therefore, these emerging topics become new or renewed challenges for the tax administrations and our wish is that at the end of this Conference, each and every one of us has greater knowledge of the experiences and valid reflections on possible solutions that help us successfully face these challenges.

We have grouped the emerging topics which we will analyze in three overarching themes:

- The use of taxes for non-fiscal purposes, that is, for an objective that goes beyond the collection of resources to finance public expenditure and, specifically, the implications that this has in the management of the tax administrations;

- Critical aspects of compliance control issues by the tax administrations, mainly those relating the complexity coming from the proliferation of sophisticated schemes for tax evasion and fraud;

- Risk Management, as a tool that favors the proactive action of the tax administration, allowing the same to direct its actions and resources in obtaining results in a more timely, efficient and proficient manner.

Therefore, to meet the objective of this CIAT Technical Conference of supporting the tax administrations in the identification of Solutions that contribute towards its strengthening, we invite you to reflect and share experiences on those three overarching issues and, in each one, discussed and analyze distinct experiences on some specific aspects.

I wish to point out that to expand on these deliberations, in addition to the valuable support of the delegations of the tax administrations of our member countries, in our technical program we have officials from international and multi-lateral organizations, and whose presence will

enrich our Conference and with who we have permanent and productive mutual cooperation, such as, the Inter-American Development Bank, the United Nations Economic Commission for Latin America and the Caribbean, the International Monetary Fund, the European Union and the Economic Cooperation Organization.

We also have the collaboration of two countries friends of CIAT, Germany and Australia. In the first case through the Federal Ministry of Finances of Germany, a country we owe much to because of the support given for many years in the consolidation of our Center and once again, for a second time, the exemplary Australian Taxation Office, which by following-up on its environment, it has implemented innovative practices to permanently and timely adapt to changes, guaranteeing in this manner the success of its mission, therefore it becomes a reference to be considered in any tax administration strengthening project.

It is in recognizing innovation and its promotion in the tax administrations of our member countries that these become the objectives of the initiative adopted by our Center during this year. In this regard and as informed, we established an annual contest to award the best innovative practices implemented by the tax administration of the member countries and associated member countries, which potentiate integrity and transparency, efficiency and competiveness.

We take this opportunity to reiterate our invitation to all the tax administrations of our member countries to participate in this year's contest, which deadline for submissions is 30 November 2008.

Upon concluding, we wish to reaffirm our commitment of maintaining CIAT as an institution that serves the tax administrations of all its member countries through its different activities, by facilitating their efforts in the quest for permanent improvement.

And finally, we would like to reiterate our recognition to the authorities and other officials of the SARS, for their excellent organization of this event and their generous and warm welcome, and I would also wish to express our appreciation for the valuable team of individuals working at the headquarters of the Executive Secretariat, which is formed by international and local officials and the Spanish and French missions, for the excellent and arduous work in supporting the organization and realization of this Conference.

Dr. Claudino Pita
Executive Secretary

TOPIC 1

THE NON-FISCAL FUNCTIONS OF TAXATION AND THEIR IMPACT ON THE TAX ADMINISTRATION

Lecture

Topic 1

THE NON-FISCAL FUNCTIONS OF TAXATION AND THEIR IMPACT ON THE TAX ADMINISTRATION

Edward Kieswetter
Chief Operations Officer
South African Revenue Service
(South Africa)

CONTENTS: *Executive summary.- 1. Functions that enhance the overall compliance culture and thus improve revenue yield from existing fiscal instruments.- 2. Functions that leverage the existing competencies of Revenue Administrations.- 3. How revenue administrations contribute to the higher purpose of state development.- 4. The South African scenario.- 5. Future national non-fiscal challenges.- 6. The regional impact.- 7. Adapting to future demands.- 8. Opportunities and Challenges for non-fiscal functions.- 9. Concluding remarks*

EXECUTIVE SUMMARY

This paper provides a perspective on those functions performed by tax administrations that are essentially non-fiscal in nature. It argues that these so-called non-fiscal functions can leverage the competencies of the administration as well as enhance its ability to perform its fiscal functions. In this way, there is an integral nexus between fiscal and non-fiscal functions.

Efforts to grow a positive compliance culture through the leveraging of taxation for poverty alleviation include investing in a vibrant supportive infrastructure for economic growth. Historically, the formation of accountable and effective states has been closely bound up with the emergence of taxation systems underpinned by a social compact imbibed with certain values and standards regarding fiscal citizenship and responsible government. So when considering the fiscal and non-fiscal objectives of taxation, it ultimately boils down to how, when and where the tax administration, in close conjunction with the policy makers, ensures that both tax and non-tax measures are administratively feasible, ultimately understood, and accepted by the citizenry.

Non-fiscal functions generally fall into 3 categories:

a) those that enhance the overall compliance culture and thus improve revenue yield from existing fiscal instruments – marketing & awareness, market segmentation, and risk management;
b) those that leverage the existing competencies of Revenue Administrations – whereby they begin to differentiate the administration and develop into a core competency, or areas of specialized expertise; and
c) those that contribute to the higher purpose of state development.

In the South African context, the new developmental responsibilities include developing stronger partnerships with other government enforcement agencies, providing assistance to government agencies with their transformation programmes, establishing assistance programs with regional revenue and customs administrations, undertaking an extended role in the various African trade bloc organisations, and further exploring how environmentally-related taxes and charges could assist in the achievement of national objectives.

In respect to these responsibilities, future South African non-fiscal challenges to be faced (as with other administrations) include: a wage subsidy, a mandatory employees' social security contribution, collective administration of a basic social security system, and reforms of the governance and regulation of the retirement fund industry. With regard to the regional impact on tax and customs administrations, the Southern African Development Community (SADC) free trade area (FTA) was launched in August 2008, with 12 states acceding and two more to follow shortly. Further ramifications for these administrations, and particularly for their non-fiscal functions, are that the SADC regional integration programme includes the establishment of a customs union for the 14 member states by 2010, a common market by 2015, a monetary union by 2016 and a single currency by 2018.

Opportunities (for both fiscal and non-fiscal functions) abound for administrations to exploit the invaluable sources of information to extend their influence, branding and credibility in support of state building, as well as to facilitate improved compliance and service though an ever-widening system of networks.

However, great challenges also lie ahead. Recent research in the field has indicated that:

a) a greater emphasis on non-material values will lower the ratio of capital to labour taxes – while directly affecting the fiscal functions of tax administrations mainly in richer countries currently, it remains to be seen what influence these shifts will have on the non-fiscal activities of tax administrations in the future;
b) policy changes aimed at reducing fiscal fraud might be a difficult task once people have assessed their equilibrium level of tax compliance – it appears from the research that individuals will attempt to recover any losses following policy changes, even if it means taking more risks; and
c) considerable emphasis is being placed on the existing "information deficit" and the associated "skills deficit", and in those areas where sharing of successful experiences would be of particular benefit.

There appears to be no end in sight in the trend in tasking revenue administrations with additional non-core functions, and questions on the administrative feasibility, impact and sustainability beg for answers. In order to deal with the additional demands of their non-fiscal functions, it is important that administrations learn to foresee and adapt to new national and global developments, and realise that they will be required to do more with less. The ultimate trade-off, however, is between focused fiscal functions on the one hand, serving the narrow interest of the Revenue administration, **OR** extending the non-fiscal functions and, in this way, serve the broader interest of the state and society.

Preamble

Revenue Administrations are creations of State with the specific intent to collect taxes through a number of fiscal instruments. The tax revenues, in turn, allow the Government of the day to provide its public with social goods and services. In this regard, Revenue Administrations are continuously in a process of reform in order to enhance their ability to collect the full amount of revenue that is provided for by law through the design of fiscal policy and instruments, on the one hand, and administrative capacity on the other.

How Revenue Administrations become more effective is an extremely complex, continuously evolving, and increasingly global endeavour. The emphasis of this paper, though, is not to expand on the efficiency of Revenue Administrations *per se*, but rather provides a perspective on those functions that may be performed by the administration that are essentially non-fiscal in nature. It does attempt though, to argue

that these so-called non-fiscal functions can, in a direct way, both leverage the competencies of the Revenue Administration, whilst at the same time enhancing its ability to perform its fiscal functions. In this way then, there is an integral nexus between fiscal and non-fiscal functions.

This paper will therefore, from a South African perspective, review the following:

- Outline the core fiscal functions of Revenue Administrations;
- Provide examples of non-fiscal functions, identifying some countries where these are to be found;
- Elaborate on the integral nexus between fiscal functions and non-fiscal functions; and
- Develop a case for Revenue Administrations to reconsider their scope and, in particular, consider how non-fiscal functions may enhance their ability to fulfil the primary mandate of collecting taxes.

INTRODUCTION

In his opening address at the inaugural meeting of African Tax Commissioners just a month ago, the South African Minister of Finance emphasised the need for Revenue Administrations to reflect on the relationship between taxation, state building and capacity development. Referring to the recent incidences of global economic shocks and its negative knock-on effect on the economic activities from which budget revenues are collected, he sketched a role for Revenue Administrations that goes beyond that of simply collecting taxes. He made the point that:

> "*Focused and well-capacitated revenue administration is critical to minimising the damage caused by such shocks, and for overcoming longer-term structural economic weaknesses. In that spirit, it is helpful to recognise its importance to sustainable development and the prerequisites for poverty reduction, tackling education backlogs and the provision of acceptable social and health services. It is also at the core of building an effective state*."

From a South African perspective, just as elsewhere in the developing world, a strong capable developmental state is needed to combat poverty and implement the Government's development agenda. The task of meeting the goal of providing a better life for all cannot be left to the market alone. But a capable and developmental state is

also one that has access to resources without growing indebtedness. The lessons drawn from the experiences of many other countries are that, unless there is a determined effort by all stakeholders to create a credible and sustainable tax compliance culture, and an increasingly broader tax base with an effective and efficient tax and customs administration, this fiscal capability will not be achieved. Efforts to grow a positive compliance culture through the leveraging of taxation for poverty alleviation include investing in a vibrant supportive infrastructure for economic growth.

Our view is that all people have a social obligation to continue the struggle for economic freedom and empowerment. This involves the pragmatics of a new type of progressive activist – an activist that will lead the way in creating and implementing the vision of a fairer, equitable and caring society focused on avoiding and reducing poverty especially in the informal economy. .

Historically, the formation of accountable and effective states has been closely bound up with the emergence of taxation systems underpinned by a relationship between governments and citizens – a social compact imbibed with certain values and standards regarding fiscal citizenship and responsible government.

In delivering on its legal mandate, the South African Revenue Service (SARS) therefore has to take cognisance of the South African context, our legacy and the importance of cultivating good fiscal citizenship with regard to payment of taxes. To this end, we constantly pursue an appropriate balance between encouraging and enforcing compliance based on taxpayer-driven behaviour. Our approach is one of collaboration with the taxpaying community and tax professionals. The extent to which we perform our duties effectively has a direct impact on levelling the economic playing field, ensuring fairness and consistency in raising government revenues and in preserving the legitimacy of our democracy. We are thus always mindful of our higher purpose in encouraging economic growth and providing the necessary resources to the fiscus to expand the delivery of essential services to the people of South Africa.

SARS has embraced the vision of fiscal citizenship through the development of various services and educational offerings to targeted segments of the tax base, espousing the importance of a citizen’s rights and responsibilities. The old adage that “the proof of the pudding is in the eating” rings true in respect of the confidence

shown and investment provided by Government. Due to the efforts of the tax and customs administration delivering on its promises, the South African government has been able to grant R90billion in tax relief, thus contributing to rising household consumption expenditure, boosted economic development, targeted fixed investment growth and the promotion of small enterprise development. These results, including improved tax morality (and thus compliance), have had an immeasurably positive impact on the economy. The fostering of compliance through the education of and communication to South African citizens and residents regarding fiscal citizenship and rigorous compliance risk management is an outlay more akin to an investment rather than an expense in building a lasting relationship with the people we ultimately serve. This value-for-money approach has underscored the importance of the concept of fiscal citizenship.

So when considering the fiscal and non-fiscal objectives of taxation, it ultimately boils down to how, when and where the tax administration, in close conjunction with the policy makers, ensures that both tax and non-tax measures are administratively feasible, ultimately understood, and accepted by the citizenry.

For now though, let us turn to the main fiscal and non-fiscal functions of Revenue Administrations, in order to clearly differentiate them from each other.

The Fiscal and Non-Fiscal Functions of Revenue Authorities

Of the 44 Revenue Bodies reviewed in the Comparative Information Series of 2006 on Tax Administration in OECD and Selected Non-OECD Countries, 19 collect most social security, 18 perform Customs functions, while 29 perform other non-tax roles. From this comparison, it is clear that non-fiscal functions have a high prevalence with Revenue Administrations.

The OECD study shows that, for the 44 Revenue Bodies, the **major tax types** they administer are as follows:

Direct Taxes	-	all administrations
Social Funds	-	19 administrations
VAT	-	41 administrations
Excises	-	30 administrations
Real Property Taxes	-	27 administrations
Wealth / Estate Taxes	-	32 administrations
Motor Vehicle Taxes	-	22 administrations

Looking more specifically at the nature of the **non-tax functions** administered by those 44 revenue Bodies, the following is observed:

Customs Laws	-	18 administrations
Welfare Benefits	-	10 administrations
Child Support	-	1 administration (only New Zealand)
Student Loans	-	6 administrations
Property Valuation	-	16 administrations
Population Register	-	2 administrations
Other	-	19 administrations

This overview begins to suggest that a business case exists for Revenue Administrations to take on more non-fiscal functions. The study suggests that very few, if any, tax administrations have escaped the additional burden of some or more non-fiscal duties, across many areas of government.

Categories of Non-Fiscal Functions

Generally non-fiscal functions deal with subsidy and benefit distribution, matters of administration, governance, partnerships and other aspects. To review whether a business case exists for Revenue Administrations to take on non-fiscal functions, this paper argues that non-fiscal functions can be looked at in three categories, viz:

1. Functions that enhance the overall compliance culture and thus improve revenue yield from existing fiscal instruments;
2. Functions that leverage the existing competencies of Revenue Administrations; and
3. How revenue administrations contribute to the higher purpose of state development.

Each of these categories will be expanded in turn.

1. FUNCTIONS THAT ENHANCE THE OVERALL COMPLIANCE CULTURE AND THUS IMPROVE REVENUE YIELD FROM EXISTING FISCAL INSTRUMENTS

A number of functions traditionally found in the realm of commerce and business have over the years crept into the activities of revenue administrations. Many of these functions are now firmly integrated into the functioning of revenue administrations. These would increasingly include functions such as:

- **Borrowing from the typical marketing & awareness function:**

  Proactive engagement with the public to raise awareness and understanding of taxpayers' obligation through a range of communication, education and marketing activities –

Increasingly revenue administrations recognize the importance of proactive engagements with its taxpaying public beyond its direct mandate to collect taxes. In this regard SARS has, for a number of years embarked active campaigns to (1) raise the level of awareness of the general need for citizens to become "fiscally responsible" through campaigns that seek to raise a culture of voluntary compliance as well as (2) active educational programmes to raise the level of taxpayers' understanding of their taxpaying obligations.

On the face of it, awareness and education does not put "money in the bank", yet the effect has a direct impact on the revenue result, thus ensuring an optimal yield from existing fiscal instruments. SARS has adopted a compliance theory that in simple terms says that if we make the effort to raise awareness and through education inform taxpayers of their obligation, then they are more likely to comply. Compliance means that taxpayers register, file and pay according to the obligations in law. Voluntary compliance therefore increases the revenue yield for a lower cost for every rand collected, within a given fiscal framework.

- **Borrowing from the typical market segmentation function:**

Moving away from seeing the taxpayer base as a homogenous base towards seeing the base in terms of specific market segments –

Understanding the taxpayer base as a composition of multiple segments has become essential in differentiating the nature of interaction between the revenue authority and its public. Arising out of this insight and further borrowing from commerce, revenue administrations increasingly talk about channel management to appeal to various preferences for how taxpayers choose to engage with the authority. This may include electronic channels, mass "retail" channels, specialized segment channels (like high net-worth segment), relationship management, etc.

In SARS we have found tremendous benefits since, at the establishment of the large business centre, the disciplines of industry segments and relationship management were introduced.

- **Borrowing from the typical risk management function:**

Another function that was conventionally found in commerce, increases the revenue yield from fiscal instruments is risk management –

Effective risk management ensures the proper identification of factors in the environment as well as factors reflected in taxpayer behaviour that may negatively impact on the level of compliance and therefore the level of revenue collection.

Risk management is integral to the identification and quantification of trends and incidences that should inform the revenue administration on activities such as which sectors or high risk taxpayers to focus on for investigative and audit work. In the case of South Africa, for example, the financial services sector was identified as a high risk about six years ago. The yield in this sector through focused risk management has resulted in an effective rate of taxation where was around 4% has increased to between 16 – 19%.

Thus increasingly, revenue administrations are investing in traditionally commercially oriented activities such as marketing, education, taxpayer segmentation, relationship management and risk management.

2. FUNCTIONS THAT LEVERAGE THE EXISTING COMPETENCIES OF REVENUE ADMINISTRATIONS

Revenue Administrations, through the effective execution of their primary mandate of collecting taxes, inevitably develop a number of competencies. Over time, one or more of these competencies begin to differentiate the administration and develop into a core competency, or areas of specialized expertise.

Examples of such areas for Revenue Administration may include:

- The management of large volumes of information and information databases and registers
- Enrolment or Registration of individuals, traders and businesses
- Collection and disbursement of monies
- Assessment and/or evaluation of tax technical and financial declarations by taxpayers
- Intelligence gathering, analysis and reporting

The above are merely examples of areas where an administration may develop deep expertise and knowledge. It is then logical to ask

the question, how else might these competencies be used in order to achieve leverage from the government's perspective.

EXAMPLE: Collection and Disbursement of monies

The collection and disbursement of monies is a key activity of any government and conducted by a number of departments and agencies. The South African Revenue Service has increasingly been seen as the agency in government that has developed the most effective revenue collection competency. Once this was understood, over time additional collection responsibilities were added. These include the collection on behalf of other government departments of: the skills levies, unemployment fund, fuel levies, universal service funds (from telecom operators), etc.

The government is currently in the process of designing a new social security system. Consideration is quite correctly currently given to use SARS as the collection agency for social security contributions by individuals. The other factor that such an arrangement leverages is the agency relationship that SARS already has with the Employers, from whom it collects PAYE (PAYE is the personal income tax from individuals which employers collect on behalf of SARS). Another example where this relationship can be leveraged is the collection of workman's compensation.

In terms of the disbursement of monies, SARS pays out refunds to individuals and the Department of Social Development currently pays out various social grants and pensions. In the future social security system, government will also make disbursements of the new social security payments.

Naturally, the question for governments is how it might enhance the overall function of collection and disbursement of monies, since opportunities for leveraging core competencies of their revenue administrations whilst improving the efficiency and cost of collections overall. Since the collection and disbursement of monies also come with the huge risk of leakage through fraud and theft, the consolidation of such activities can also minimise such risk.

EXAMPLE: The Management of Registers and Registration

Another core competency is the management of registers and the process of registration. In South Africa we have, for example,

SARS who manages the register for individual taxpayers, whilst the Department of Home Affairs manages the population register. A huge challenge exists for both agencies to ensure the integrity of personal information on individuals. The register has a significant overlap since the majority of individual taxpayers are also citizens. We often find discrepancies between the two registers of information such as first names, surnames, personal identity number, and residential address (or contact information). There are various reasons why, over time, these discrepancies arise, but opportunities arise for consolidating the register integrity between state agencies.

The future plans for a national social security system where individuals will be both contributors and recipients of the systems, will require the same personal information. In this regard, key questions arise for how government may rationalise the effective and efficient management of a consolidated register that contains all the current information for managing the population register, tax register, social security register, register of employees, etc.

An opportunity therefore exists for leveraging the core competency of register management that the revenue administration has developed. The revenue administration of Sweden is an example where the population register as well as the tax register is managed by the same authority.

Similarly the overlap of the tax register for businesses, which is managed by SARS, overlaps with the register of companies, which is managed by the Department of Trade and Industry (DTI). Currently a single business must register with the DTI to operate as a company or business entity, whilst separately register with SARS for the relevant taxes. In this regard, the process of registration may also be consolidated. This would further reduce the administrative burden on businesses, whilst leveraging a core competency for government.

Further examples where leveraging opportunities are explored in a number of revenue administrations includes:

- fuel rebates and grants
- housing and care allowances and premiums
- collection of debts on behalf of other state agencies
- social security payments
- regional (State or Provincial) service levies and rates
- provincial and local authority revenue allocation

- export refunds
- distribution of investment incentives
- social, disabled, aged and other state grants
- management of business and corporate registers
- management of statistical functions required by the state
- management of state property
- valuation and appraisal management and control
- administration of premiums
- corporate law
- savings schemes
- distribution of federal / provincial payments of social program
- management of judicial fees,
- managing the provision of information sharing arrangements,
- provincial authority fees
- liquor industry administration,
- permanent residence applications
- lottery and gambling control / gaming casinos levy

3. HOW REVENUE ADMINISTRATIONS CONTRIBUTE TO THE HIGHER PURPOSE OF STATE DEVELOPMENT

As stated, revenue administrations have an integral role towards state building. For states, especially those who have huge developmental challenges, access to resources is key. No government can function without money. In a direct way, therefore, the success of revenue administrations serves a higher purpose in the national interest and nation building. It makes a contribution towards the overall capacity of the state in a number of ways:

- **Financial resourcefulness:** Making financial resources available for governments to address issues such as the provision of basic services of primary healthcare, housing, water, sanitation, electricity, education. In developing countries, the eradication of poverty and elimination of preventable diseases presents huge challenges.

- **Customs & Border Control:** In certain countries, revenue administrations have been given the additional responsibility of customs and border control. This role is integral to the facilitation of trade as well as the integrity of the domestic economy. The effect of this role is to retain an appropriate balance between legitimate and illicit flow of people, goods and services across national borders. In executing an effective customs and border

control function, those revenue administrations that have been entrusted with this responsibility, play an important role which goes way beyond simply the administration of fiscal instruments and the collection of revenues.

- **Strengthening democracy:** Through their efforts to positively influence the compliance culture, revenue authorities make a measurable contribution towards the overall culture of fiscal responsibility in particular, and civil responsibility in general. In this regard, this contribution lays down a basic tenet for civil obedience and in turn strong democratic institutions.

- **Instilling national pride and autonomy:** More than 40 countries (according to the OECD) fund their national expenditure with a donor funding to tax revenue ratio of 50% or more. This over-dependence on donor funding can hardly be a basis for sustainable national pride or autonomy. In the effective execution of their fiscal responsibility, revenue administrations, in a very direct and significant way, contribute to the fabric of society.

- **Role-modelling good governance:** The effective functioning of a revenue administration demonstrates that government institutions can work effectively, deal with issues of integrity, and deliver on the mandate of service delivery. In addition to service delivery, governments have to deal with matters of counter terrorism, cross-border transactions, fraud and corruption. It augers well for the effective functioning of government in general when government has a role model of efficacy. In this regard, well functioning revenue administrations are prime candidates.

4. THE SOUTH AFRICAN SCENARIO

From an historical perspective, South Africa has not escaped the additional responsibilities imposed by its respective governments for handling non-fiscal functions. The former Department of Inland Revenue and the Department of Customs & Excise were encumbered with various additional non-core functions ranging from the collection of provincial licences and taxes, corporate annual duties, tithes, liquor licence industry administration, fuel and insurance levies, fines and forfeiture accounting, and green taxes collection. As of 1998, the “new” administratively-autonomous South African Revenue Service (SARS), incorporating the former two separate Departments, either inherited some of these accountabilities, or has since acquired additional non-

fiscal duties as part of the lead taken by the new organisation in the government transformation process.

Within the context of the evolution of the developmental state, new non-fiscal functions were identified, these forming integral parts of the county's developing fiscal and economic policy. Others became part of the strategic approach adopted by SARS within important areas such as the development of the public sector – comprising of efficient and stable institutions capable of monitoring, evaluating and effectively implementing complex policy programmes that impact positively across the economy and society. The motivation for this was that the state must be capable of establishing institutions that prevent (or buffer) the inevitable effects of dynamic change from unfairly falling on those least able to adjust to them through a comprehensive system of support without adversely affecting other dimensions of the economy and society.

SARS has recognised its new developmental responsibilities through:

- developing and maintaining strong partnerships between other government enforcement agencies for the combating of crime and eliminating corruption;
- providing assistance to government agencies with transformation programmes to consolidate democracy;
- establishing assistance programs with regional revenue and customs administrations in respect of training, diagnostic and benchmarking studies;
- undertaking an extended role in the various African trade bloc organisations; and
- exploring how environmentally-related taxes and charges could assist in the achievement of national environmental goals and objectives in a cost effective and efficient manner.

5. FUTURE NATIONAL NON-FISCAL CHALLENGES

Looking ahead, additional non-fiscal functions, which SARS will have to provide and manage, relate to the establishment of systems and processes to deal with social-security type taxation and wage subsidies for every working citizen in the country. In his State of the Nation Address on 9 February 2008, President Mbeki signalled Government's intention to establish a broad-based, contributory social security arrangement by 2010, to accompany reform of the retirement

fund industry. Preliminary proposals were set out in the 2007 Budget Review, and elaborated in a discussion paper released by the National Treasury on 23 February 2008, drawing in part on work undertaken by the Department of Social Development. Consultations with stakeholders are to be held shortly, under the auspices of the National Economic Development and Labour Council (NEDLAC).

The main recommendations are:

- a wage subsidy, to be implemented as a credit to employers through the monthly pay-as-you-go personal income tax system;
- a mandatory employees' social security contribution, also implemented through the monthly PAYE tax return, to finance a basic retirement savings arrangement and improved earnings-related unemployment, disability and death benefits;
- Collective administration of a basic social security system, drawing on modern information and data warehousing capabilities;
- Complementary reforms of the governance and regulation of the retirement fund industry, which will continue to provide occupational and individual retirement plans to supplement the basic social security scheme; and
- Reforms to the tax system aimed at maintaining sufficient incentive to provide adequately for retirement while addressing inequities and complexity in the current system.

Full phasing in of these reforms will take several years. Careful attention will therefore need to be given to critical policy and design issues, as well as administrative transition and sequencing aspects, while taking into account the existing arrangements and institutional development challenges of comprehensive social security reform. South Africa already has a substantial social assistance grant programme, financed through the fiscus and amounting to over 3 % of GDP. A large and well-established retirement fund industry is also in place (comprising over 13 500 funds), which raises interesting and important questions about the appropriate place and structure of a collective social security arrangement. Internationally, there are many different ways in which income security and retirement funding are arranged, making this a reform arena in which there are competing views and powerful interests to be considered. Alongside the macro-economic determinants of economic growth, employment and trade performance, this is a reform project that will have profound and enduring significance for the structure and cohesion of South Africa's social development.

This vital developmental non-fiscal responsibility forms an integral part of the SARS modernisation agenda and continues to receive high priority. To date, agreement has been reached with key stakeholders on the role of SARS and the strategy to deliver on social security tax and the wage subsidy. High-level operational designs for social security administration have been developed to provide for automatic enrolment, direct payroll deduction and limited individual choice. A scale-driven model allowing for delivery of both "in-house" and other existing government capabilities, as well as through the private sector, has been developed and shared with Government's Interdepartmental Task Team and Inter-Ministerial Committee overseeing the program.

6. THE REGIONAL IMPACT

The long-awaited free trade area (FTA) for the Southern African region was launched in August 2008 during the annual summit of the Southern African Development Community (SADC), with 12 states acceding and two more to follow shortly. The establishment of the FTA will bring regional economic integration a huge step further as well as increased competition and more affordable goods for customers, as no import tariffs will be imposed on an estimated 85 per cent of all trade in goods. The impact on the business of both tax and customs, as well as on people at all levels, during the implementation of the FTA, will require new knowledge and skills to enter the larger market of the sub-region.

Further ramifications for the tax and customs administrations are that the SADC regional integration programme includes the establishment of a customs union by 2010, a common market by 2015, a monetary union by 2016 and a single currency by 2018. From a regional viewpoint, the development of the African Union and the New Partnership for African Development (NEPAD), the regional economic integration of the current Southern African Customs Union (SACU) and the enlarged SADC Customs Union by 2010, the eventual establishment of regional trade corridors and accompanying security concerns will all place a heavy non-fiscal burden upon the shoulders of SARS.

7. ADAPTING TO FUTURE DEMANDS

The strategic challenges that SARS is expected to meet requires a fine balance between the delivery of core operations whilst accelerating implementation of programmes to meet the challenges of the future. Following an in-depth review of the existing SARS operational

and infrastructural footprint, specifically focussing on resource distribution, and underpinned by the administration's evaluation of the various taxpayer segments, the organisation has embarked upon a comprehensive Modernisation Programme to implement a new operating model, consisting in the main of a differentiated approach to engaging with taxpayers and traders. The resource distribution mismatch identified has necessitated the administration to adapt and adopt a customised approach to meet the demands of the main segments of the tax base.

The environment within which SARS is expected to operate, both at present and in the future, takes on a greater share of the national developmental agenda and, in turn, more than the traditional core statutory functions and mandates, extending further into the realm of non-fiscal functions.

8. OPPORTUNITIES AND CHALLENGES FOR NON-FISCAL FUNCTIONS

The advantages of having to deal with increasingly diverse non-fiscal functions by tax administrations are viewed in the main from a South African perspective. However, these advantages have and will most probably continue to be experienced in most progressive administrations around the globe, both today and in the near future.

The identification, acquisition, analysing, storing, maintenance, sharing and ultimate use of information will form one of the vital cornerstones of progressive, effective and efficient tax administrations. Opportunities abound regarding the invaluable sources of information for administrations to extend their influence, branding and credibility in support of state building, and to facilitate improved compliance and service though an ever-widening system of networks. From a governance perspective, the scope of information use is increasing exponentially and will stand any regulatory authority in good stead, enabling them to exploit information both for fiscal and non-fiscal functions.

To a greater or lesser extent, social values are influencing, and indeed shaping, policy outcomes. Tax policies and administrative systems are not immune to these social transformational drivers and are even an inherent part of an evolutional process. These shifts will in one way or another impact on the manner in which tax administrators will have to adapt to new and emerging trends. Recent research conducted

by the Leibniz University of Hannover in Germany[1] analysed how the relative importance society ascribes to non-consumptive values affects its choice of tax structure, i.e. the mix of capital and labour taxation. It was shown that a greater emphasis on non-material values will lower the ratio of capital to labour taxes. Although directly affecting the fiscal functions of tax administrations mainly in richer countries currently, it remains to be seen what influence these shifts will have on the non-fiscal role and activities of tax administrations in the future, or what impact the adoption of these new social values by the rich tax base will have, those contributing the lion's share of fiscal collections in developing countries.

In addition, research conducted in Canada[2] recently indicated that policy changes aimed at reducing fiscal fraud might be a difficult task once people have assessed their equilibrium level of tax compliance. It appears from the research that individuals will attempt to recover any losses following policy changes – even if it means taking more risks. The research concludes that policy makers will have to seriously contemplate establishing what levels taxpayers consider as a 'fair' level of taxation, that balance their relative level of tax contributions with what they expect to gain from them. This then entices one to consider a number of options insofar as a balance between fiscal and non-fiscal functions of tax administrations in order to alleviate the risk of counteracting the possible tendency of taxpayers to 'balance the books', relative to their gains and losses from taxation, by taking greater risks if the perception of unfairness is evident.

At a special meeting held recently at New York University, as part of the project on South-South Sharing of Successful Tax Practices[3], considerable emphasis was placed on the existing "information deficit" and the "skills deficit" (in the sifting, analysis and connection of relevant information), which are proving to be a great challenge for tax policymakers and administrations, and areas where sharing of successful experiences would be of particular benefit. In particular:

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[1] *(Post-)Materialist Attitudes and the Mix of Capital and Labour Taxation - Leibniz Universität Hannover - Discussion Paper No. 404 - July 2008*

[2] *The Effect of Perfect Monitoring on Matched Income on Sales Tax Compliance: An Experimental Investigation – CIRANO – a private non-profit research organisation – Montreal, Canada - July 2008*

[3] *REPORT OF MEETING on Revenue's Role in the Quest for Inclusive Development: What Works and What Can Work Better? South-South Sharing of Successful Tax Practices - Special Unit on South-South Cooperation of the United Nations Development Programme - New York University - May 2008*

- there was a need to improve information collection capabilities, including by the effective use of Exchange of Information articles in tax treaties (or of information exchange agreements where comprehensive tax treaties do not exist) and to improve the capacity for, and techniques of, analysing and managing information; and
- The well-thought-out use of information technology can support improved taxpayer compliance, and the costs and upheavals of such modernisation meant that shared experience and advice could be of special benefit in this area.

9. CONCLUDING REMARKS

In order to deal with the additional demands of their non-fiscal functions, it is important that tax administrations learn to foresee and adapt to new national and global developments, and realise that they will be required to do more with less. The pressures being brought to bear on successful tax administrations, in both developed and developing countries, to manage non-fiscal functions were aptly summarised by the Assistant Commissioner responsible for Field Audit & Investigation in the Hong Kong Inland Revenue Department, when he stated that:

"The starting point for an effective audit strategy is to recognise the limits of what can be achieved. As it is not cost effective to check each return filed, the integrity of the tax system will depend on the tax audit, which has been extended to the traditional tax administration to include non-fiscal issues (e.g. money laundering, anti-terrorist financing, etc.) The extensions of mandates demand resources, training and closer partnerships with other law enforcement agencies." [4]

Considering that there appears to be no end in sight in the trend in tasking revenue administrations with additional non-core functions, certain questions of administrative feasibility, impact and sustainability beg for answers - from an administration perspective - as to the impact that these extra duties have on their core business functions. Every tax administration will have to prepare in advance for the inevitable encroachment on its core functions to alleviate potential surprises by identifying, researching, planning, negotiating and, in some cases, adopting a reasonable, yet tough, stance on additional infringements on their primary functions. With this in mind, it is advisable to keep abreast with global best practice to proactively bring this to the attention of the relevant policy makers and legislators.

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[4] *Development of the Tax Audit Framework of Hong Kong, China - ADB Institute 17th Tax Conference - Executive Summary of Conference Proceedings - October 2007, Tokyo*

With developing countries generally experiencing a considerable gap between the level of revenues collected and the level of public funds required for their development, the structural issues related to taxation indicate that these countries in particular have to adopt a long-term vision for taxation reforms.

Equally important is the politics of taxation, as emphasized in Lora et al. (2006)[5]. Taxation is highly path-dependent due to resistance of the elites, and the wide-reaching effects of taxation, as well as the common pool nature of tax revenues, make it difficult to reach the cooperative solutions on establishing simple, efficient and equitable tax systems. It is politically, and therefore practically, challenging to make fundamental changes to an established tax structure overnight. Hence, the success of any tax revenue reform is highly dependent on the political support and commitment of Government. The discussion on revenue reforms must be country specific and reliant on comprehensive analyses of the country's revenue potential, revenue performance, and political readiness to undertake difficult reform measures.

It is therefore incumbent on tax administrators to carefully consider all the strategic choices and options that they have at their disposal to meet the growing demands from policy makers for reform, greater revenue generation, as well as the adoption of non-fiscal functions.

The ultimate trade-off is between focused fiscal functions on the one hand, serving the narrow interest of the Revenue administration, **OR** extending to include non-fiscal functions and, in this way, serve the broader interest of the state and society.

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[5] *Lora, Eduardo and Mauricio Olivera. 2006. "The Political Determinants of Taxation (preliminary version)." LACEA-PEC.*

Case study

Topic 1.1

ENVIRONMENTAL PROTECTION TAX MEASURES

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CONTENTS: I. Introduction.- II. The environmental tax reform in Germany.- II.1. Historic background.- II.2. Implementation of the environmental tax reform.- II.3. The measures in detail.- II.4. Collection and administration of the "environmental tax".- II.5. Effects of the environmental tax reform.- III. Other market instruments with environmental objectives.- III.1. Tax on vehicles.- III.2. Non-tax instrument for climate protection.- III.3. Future measures.- III.4. Other tax measures discussed.- IV. Conclusions

POSSIBILITIES AND LIMITS OF ENVIRONMENTAL TAXATION

I. INTRODUCTION

Climate protection as a future challenge

The International Community faces the challenges posed by global climate change. To respond to this harmful tendency affecting the environment and the economy, it is necessary to adopt prompt measures in the international, national and local spheres.

Internationally, the Kyoto Protocol represents a binding framework for many countries. In this regard, Germany has committed to reducing its greenhouse gas emissions by about 21% from 2008 to 2012 as compared to 1990.

This commitment implies extremely rigorous work and a firm consensus, since it involves several policy areas with very different goals. Synergies shall be established wherever possible. Climate protection issues are especially linked to those of secure energy supply. Expansion plans for renewable energies along with increased energy efficiency help meet these two major goals.

The truth is that, in the long term, failing to adopt effective measures would be more costly than adopting them, even if in the short term they might undermine economic growth, for example. In this regard, tax instruments have a significant control function, since they are specially capable of providing the right stimuli for sustainable development. It is worth noting that this statement holds true for all tax instruments, i.e., not only taxes but also charges, contributions, direct and indirect subsidies, such as the compensation on solar energy supply and emissions trade. The aim is to combine environmental taxes and these tax instruments and regulatory measures to create a compelling global concept.

The importance of environmental taxes in climate change

When considering the possibility of implementing taxes for climate protection, two distinct approaches should be noted:

– Imposing heavier tax burdens on environmentally unfriendly actions. The advantage of this approach is that this kind of measure in principle does not require additional budgetary funds. However, in many cases it will be necessary to balance environmental policy goals with the repercussions these may have in terms of competitiveness for the companies affected. From the European perspective, for example, it is essential to reconcile these measures with domestic market principles.

  If the desired effect is achieved, a taxation issue will arise, since collections from environmental taxes are regressive. However obvious this may sound, it should be considered when designing environmental taxes. In practice, it is clear that these competing goals should be enforced in a coordinated fashion. Ultimately, it is a process of enhancement.

– Promoting environmentally friendly actions by means of tax benefits which serve as incentives aimed at changing other actions. Notwithstanding, the main *raison d'etre* of taxation is to create a steady flow of public revenue. For this reason, the tax benefits and compensations granted to reward desired environmental actions should be harmonized with the goal of achieving a sound budgetary policy.

  In granting tax benefits, tax administrations should accurately define and limit the behaviors to be rewarded, which may result in a more complex tax law and greater burocracy.

Environmental Taxation in Germany

Taxation on energy provides a good example of the balance between tax collection and control purposes.

Following the Environmental Tax Reform, effective since April 1, 1999, Germany has taxed energy by raising the tax rates on liquid and solid fuels, and on electricity. This measure laid the foundations for energy saving efforts. Likewise, a reduction of pension contributions was funded with the resulting increase on collections, providing a relief on the labor side. Better framework conditions were thus created for the labor market.

This presentation will first discuss the motivations, goals and various measures implemented in the framework of the environmental tax reform. With the reform currently in place for several years now, we can already mention the first experiences gathered during its implementation, as well as its repercussions.

However, Germany does not limit itself to considering environmental issues in establishing energy taxation. For this reason, I will also discuss other tax measures aimed at achieving an essential environmental control.

The implementation of taxes aimed at achieving the established environmental goals is restricted. Thus, some of the possible measures discussed in this context, in addition to actual measures taken by certain countries, are not conducive from the German perspective. These aspects shall also be discussed here.

The International Framework

Although international goals have been set for climate protection, the situation differs considerably from country to country. Starting from a specific economic and social scenario, each country shall develop a package of measures which conforms to these circumstances. However, it is impossible to protect the climate through isolated efforts; international cooperation is required.

Finally, this presentation shall provide a detail of these international aspects, in particular the European framework, which is of utmost importance for Germany.

II. THE ENVIRONMENTAL TAX REFORM IN GERMANY

II.1. Historic Background

After 16 years of conservative-liberal rule, there was a shift in the German Winter of 1998. The new Federal Government, headed by German Chancillor Gerhard Schröder, emerged from the coalition between social democrats and the environmentalist party Bündnis 90/ Die Grünen.

An environmental tax reform had been a topic of discussion for several years, however unsuccessfully, even with environmental and economic framework conditions prompting the need of an upcoming reform initiative.

In 1998, energy costs were at their historic minimum. In 1997 and 1998, the world price of crude oil fell substantially as a result of supplies being far greater than consumption. In 1998, the energy market started its liberalization process, which led to lower electricity prices.

After CO_2 emissions were dramatically reduced in the 90's, the reunification of the two German states continued the downward trend, although at a slower pace. Insufficient efforts in terms of climate protection policy seriously jeopardized the administration's target of reducing gas emissions by 21%.

On the other hand, the labor situation continued to worsen. High non-salary labor costs threatened existing jobs, or even prevented the creation of new ones.

By 1998, the aggregate of social security contributions (pension insurance, sickness, assistance and unemployment) had crept to 42.1%. Social security contributions reached a historic peak of 20.3%.

This scenario shaped the Environmental Tax Reform, which was passed on April 1, 1999, with the purpose of:

- Taxing energy by raising the rate on liquid and solid fuels and electricity, thus laying the foundations for energy savings with this measure; and
- Providing a relief for the labor component by reducing social security contributions and funding said reduction from the resulting increased collection to achieve better framework conditions for the labor market.

II.2. Implementation of the Environmental Tax Reform

On April 1, 1999, the first stage of the Environmental Tax Reform became effective with the passage of the **Environmental Tax Reform Law** (*Gesetz zum Einstieg in die ökologische Steuerreform*). In the West, the hydrocarbon tax rate was raised on liquid and solid fuels, and a tax on electricity was introduced. The term "environmental tax" soon became widespread, although it was not a stand-alone tax.

The Law that provided for the continuation of the Environmental Tax Reform (*Das Gesetz zur Fortführung der ökologischen Steuerreform*) passed on December 16, 1999 contemplated four successive annual increases of the hydrocarbons tax rate on liquid fuels and the electricity rate in 2000 through 2003, effective on January 1st of the respective four years.

On November 1, 2001 an amendment was made to provide for distinct taxes on hydrocarbons (gas and diesel oil) depending on sulphur content. The difference of 1.53 cents per litre compared to liquid fuels with sulphur was first applied on liquid fuels with low sulphur content (up to 50 mg/kg) and, starting on January 1, 2003, to those free of sulphur, with up to 10 mg/kg.

On the effective date of the Law for the continuation of the Environmental Tax Reform (*Gesetz zur Fortentwicklung der ökologischen Steuerreform*) – January 1, 2003 – which started on December 23, 2002, the fifth tax category of the environmental tax was amended. Changes included a raise on the hydrocarbons tax for natural gas, LPG and heavy fuel-oil.

The last stage of the Environmental Tax Reform became effective in 2003. This completed the project. In 2003 and 2004, specific amendments were made with the purpose of eliminating subsidies in the West.

With the **New regulatory law on taxation of energy products and amendment of the electricity tax law** (*Gesetz zur Neuregelung der Besteuerung von Energieerzeugnisse und zur Änderung des Stromsteuergesetzes*) of August 1, 2006, the new law on energy tax, which had been amended radically, superseded the law on hydrocarbons tax effective until then, in addition to amending the provisions of the electricity tax. However, regular tax rates in force until said date were not amended, since tax collection resulting from the measures taken in the framework of the Environmental Tax Reform

was still necessary for supplementary services under public pension plans, especially in order to relieve pension fund contributions.

II.3. The Measures in Detail

Table 1 in the annex shows the evolution of regular tax rates on energy products from 1999 through 2008.

Likewise, in the framework of the Environmental Tax Reform, a differential regulation was introduced involving specific tax incentives, which was essential due to social, environmental and economic policy reasons.

However, as a member of the European Community, Germany is not completely free in terms of the drafting of special provisions. Any tax incentives consisting of subsidies which might enable economic advantages for the beneficiaries shall be subject to the European Commission's aid control function. This aid control function is responsible for controlling any such measures aimed at ensuring arm's length competition in the European Union's domestic market.

As from the signing of the European Community's charter, state subsidies capable of disrupting arm's length competition are incompatible with the Commonwealth any time trade is affected between member States.

European Union member states planning to introduce tax incentives shall submit them in advance for approval by the European Commission. For this reason, the Federal Government was compelled to report the tax benefits foreseen to this body for subsequent approval as per the Environmental Tax Reform.

The main tax incentives are:

Industrial Tax Incentives
Since the beginning of the Environmental Tax Reform in April 1999, industrial, farming and forestry corporations are awarded an overall tax incentive based on their international competitiveness to stimulate the use of electricity and solid fuels (fuel-oil, natural gas and LPG). In Germany, some 120,000 businesses benefited from this relief.

In **Table 2** in the annex you will find detailed information on the behavior of the tax pressure on industrial, farming and forestry corporations.

This incentive was amended several times over the years. Initially, businesses received a tax reduction of 80% on tax raises from 1999 through 2002, which became effective on April 1, 1999. From 2003 through 2006, this benefit was reduced from 80% to 40% (<u>still on tax raises</u>).

Since 2007, the 40% reduction for natural gas and LPG is applied to the whole tax rate on solid fuels, i.e. including existing taxation prior to 1999. As a result, corporations only pay 60% of the regular tax rate on electricity and solid fuels. However, by virtue of the EU's subsidy controls, a tax reduction representing approximately 20% of the whole fuel-oil tax rate is granted.

The EU's subsidy control function approved this general tax benefit until December 31, 2012.

Tax Cap on Intensive Use

Corporations which have received this benefit but are nonetheless taxed with special taxes are further granted the additional right to a reduction the value of which shall be established, on the one hand, by the Environmental Tax Rate (except for the share accounted for by liquid fuels) and, on the other, by a reduction on social security employer contributions. In Germany, this special benefit is called "Spitzenausgleich" (tax cap on intensive use).

Some 20,000 German corporations benefited from this relief.

In June 2007, the EU's subsidy control finally granted authorization to continue applying this tax cap until December 31, 2006, thereby extending the term until December 31, 2012.

The condition was for Germany to make continuation of this relief contingent upon compliance with the goals set forth in the agreement signed on November 9, 2000 between the government of the Federal Republic of Germany and German companies with the purpose of assuring climate preservation (Climate Protection Agreement) and thorough control of said compliance. This led Germany to adopt a four-stage model to be observed vis-à-vis de EC. Legal regulation of Stages 2-4 is still pending. The EC required the implementation starting in 2009 of an ambitious control system with the purpose of monitoring compliance with the goals. This system is being rolled

out currently by the Federal Government. I will now present detailed information on the four stages:

1st Stage*:*

The tax cap on intensive use benefit was extended until December 31, 2009. In addition, a requirement was introduced to confirm that the goal of the Climate Protection Agreement is 96% fulfilled by December 31, 2009 and 100% fulfilled by December 31, 2012.

2nd Stage:

The tax cap on intensive use shall be extended until December 31, 2010 provided that in 2009 the German Government proves by means of an independent opinion that by December 31, 2009 the goal is likely to be fulfilled by 96% and by December 31, 2012 it is likely to be fulfilled by 100%. This result shall be published in the Federal Official Gazette no later than on December 31, 2009. If this is not the case, the tax cap on intensive use shall expire on December 31, 2009.

3rd Stage:

The tax cap on intensive use shall be extended until December 31, 2011 provided the Federal Government proves by means of an independent opinion that by December 31, 2009 the goal was effectively 96% fulfilled and that by December 31, 2012 it is likely to achieve it by 100%. This result shall be published in the Federal Official Gazette no later than on December 31, 2010. If this is not the case, the tax cap on intensive use shall expire on December 31, 2010.

4th Stage:

The tax cap on intensive use shall be extended until December 31, 2012 provided the Federal Government proves by means of an independent opinion that by December 31, 2012 the goal is expected to be 100% fulfilled. This result shall be published in the Federal Official Gazette no later than on December 31, 2011. If this is not the case, the measure shall expire on December 31, 2011. Likewise, in principle, only 80% of the tax cap on intensive use shall be refunded by the year 2012. Businesses shall receive the remaining 20% only after the Federal Government confirms in the year 2013 that the Climate Protection Agreement goal was 100% fulfilled in 2012. This result shall be published no later than on December 31, 2013 in the Federal

Official Gazette. If this is not the case, the remaining percentage shall not be refunded.

Other incentives

Partial refund of the hydrocarbon tax for diesel used in farming and forestry (gasoil).

Benefit to co-generation stations (for example, co-generation plants, which generate electricity and heat simultaneously), provided their performance stands at 70% +

Tax reduction until December 31, 2018 on the use of natural gas and LPG as liquid fuel. No caps are set on this benefit for public transportation vehicles. Thus, it also benefits forklift trucks used by businesses.

Benefit for railway carriers and the public passenger transportation network: a reduced rate on electricity used in operating railway transportation and trolleybuses, and a refund of slightly over 40% (which stood at 50% at year-end 2002) on hydrocarbon tax raises, contingent on the Environmental Tax Reform underway.

Tax exemption on the electricity obtained exclusively from water, wind and solar energy, geothermal energy, landfill gas, biogas or biomass, only if taken exclusively from a grid fed by renewable energy resources or from a similar line. Exception: electricity from hydro plants with installed generator power of 10 Megawatts.

Tax benefit for fuel-oil with low sulphur content starting in 2009.

You will find the detailed evolution of each of the above tax rates on **Table 3** in the Annex.

II.4. Collection and Administration of the "Environmental Tax"

The Federal Customs Administration is the German body responsible for collecting the tax on energy and electricity. These taxes are also collected by the Federal State.

In 2007, revenues from this tax were 45.3 billion Euros.

The main provisions on tax accruals and collection are harmonized within the European Community.

Tax Collection

The energy tax is already collected from producers in the late parts of the trade chain (wholesalers), the so-called "bonded warehouses", and is charged to consumers by including it in sales prices. It is possible to **produce** and **store** energy products in bonded warehouses **free of taxes**. The tax is accrued only once the energy product is removed from the bonded warehouse or when it is moved for use within the premises. The taxpayer is the owner of the bonded warehouse.

It is possible to send energy products free of taxes to other bonded warehouses in German territory or to authorized bonded warehouses or shipping agents in other EC member States, or to export them to third countries.

If an already taxed energy product is purchased for industrial purposes from another EC member State, the tax is accrued upon receiving it in German tax territory or entering it, if it is the purchaser who is moving it. In the latter case, the taxpayer is the purchaser.

If a product is **imported** from a third country (not belonging to the European Community), EC customs provisions shall be applicable in terms of the time of accrual and deemed taxpayer.

Tax benefits and reliefs

There are various procedures to determine a tax exemption on energy or electricity. The law mentions tax exemptions and deductions. The provisions of the energy tax recognize a large number of applications eligible for tax reliefs.

Tax benefits

Tax benefits can be divided into tax exemptions and tax reductions:

- **Tax Exemption**

  If taxed products are **used** in given applications they may be **tax exempt**. In most cases, it is necessary to obtain a formal authorization for this type of procedure. However, the provisions

of the energy tax foresee the need for a blanket permit for a series of cases.

– **Tax Reductions**

In addition, reduced tax rates apply for given products if the following operations are performed:

- Combustion to obtain heat or
- Operating gas turbines and internal combustion engines in beneficiary plants.

Tax Reliefs

A relief is the pardon, refund or offset of the total or partial amount of an already accrued tax. With this measure, the beneficiary obtains an advantage equivalent to a tax exemption or reduction. As a general rule, tax exemptions or reductions occur **before** the application, whereas tax reliefs occur after it.

II.5. Effects of the Environmental Tax Reform

Energy prices

The Environmental Tax Reform resulted in an upward trend for electricity, liquid and solid fuel prices. Non-tax and market factors also influence the prices of each energy type.

It is worth noting that the energy sector can react relatively quickly in terms of pricing in case changes arise, whereas the tax components in energy pricing are quite static and affect pricing only in the rather long term.

Recent changes in liquid fuel pricing are influenced by the fluctuations in the international price of crude oil, and the dollar ratio; conversely, the energy tax has a low impact in this scenario.

Precisely the fact that in Germany the price of diesel oil is now close to that of premium gas shows that the tax pressure on energy is not the reason, since diesel oil is taxed at 18 cents less per litre.

Unlike liquid fuels, taxes on solid fuels (light fuel-oil and natural gas) have a smaller share on price. The VAT and hydrocarbons tax portion in the price of fuel oil is lower than 30%. The Environmental Tax

Reform did not alter this ratio significantly, since the hydrocarbons tax was raised only once by approximately 2 cents per litre.

A 2004 research paper by the German Institute of Economic Research (*Deutsches Institut für Wirtschaftsforschung*) on the tax pressure or relief of the environmental tax showed that as a result of the – highly publicized in its early stages - Environmental Tax Reform, consumers became significantly more aware of energy use.

Repercussions for Businesses

The mentioned paper by the DIW further showed that businesses benefited from the environmental tax in many ways, either directly or indirectly.

The main winners are businesses which boosted the production and expansion of energy-efficient products and/or lowered their energy costs by implementing energy-efficient production processes. Other winners were the businesses which profited from special provisions. Furthermore, there was a growing use of services provided by energy consultancy firms.

It is important to mention that all businesses were able to lower non-salary related labor costs. This is of special benefit for businesses proving that they are labor-intensive rather than energy-intensive. The tertiary sector in particular will continue to benefit.

The revenues from the environmental tax are mostly used to relieve the pension system. In the past, the percentage contribution to the pension system grew steadily, and overburdened the labor market to a greater extent. Thus, as mentioned earlier, the share contribution by employers and employees to the pension, sickness, assistance and unemployment insurance in early 1991 amounted to an average of 35.2% of the compensation subject to social security contribution. By 1998, it had already crept to 42.1%.

Had additional revenues not been available, contributions to the pension system would have been raised by 1.7% in the years 2003, 2004 and 2005. With the environmental tax, it is possible to improve the framework conditions which enable the keeping of existing jobs as well as the creation of new ones.

Likewise, the Environmental Tax Reform promotes investment aimed at energy savings and further development of future eco-techniques. Under this scenario, Germany could strengthen its position as

international leader in the area of innovative energy technologies while modernizing and boosting the German economy. Together with the growing demand for efficient products, this also allows for the creation of new jobs.

III. OTHER MARKET INSTRUMENTS WITH ENVIRONMENTAL OBJECTIVES

Surely the Environmental Tax Reform with its sweeping measures, which were widely discussed with the public, is the best known environmental market instrument ever implemented in Germany.

III.1. Tax on Vehicles

In addition to the energy tax, another relevant German tax is that on motor vehicles, payable on an annual basis and which is also relevant in terms of environmental policy.
For personal motor vehicles, the tax base is tied to the engine's cubic capacity and emissions of contaminants, pursuant to European regulations.

Until the end of 2010, there shall continue to be a tax benefit on vehicles equipped with diesel particle filters. This measure combines the two possible aims of taxes for environmental control purposes – punishing harmful behaviors on the environment and rewarding environmentally friendly behaviors.

As from April 1, 2007, a supplementary amount of 1.20 Euros per 100 cm^3 is charged on diesel vehicles considered not too low in particle terms. This measure shall be effective for 4 years. The supplementary amount was created, first of all, to fund the benefit granted until December 31, 2010 to diesel vehicles equipped with particle reduction systems.

III.2. Non-tax Instrument for Climate Protection

The creation of environmental taxes encompasses many aspects: it is always a delicate balance between a means of collection, a safeguard for the international competitiveness of the businesses affected, and a distinct control mechanism. If the revenue raised is used with the purpose of adopting environmental measures, an already complex system would become even more complex.

In view of the contradictory effects resulting from environmental taxation in given situations, in general, a set of measures should be designed based on market instruments, where taxes are but one of the many elements used, focusing mainly on funding government functions.

It is not possible to use taxes as the sole control tool. Instead, a strategy is needed which does not only include tax instruments but also resorts to a comprehensive approach with the purpose of outlining a sustainable policy and achieving successful communication. First and foremost, the goals (which should be heterogeneous wherever possible) should be defined and harmonized so that the necessary means for their implementation can be sought at a later stage.

For example, Germany increasingly promotes biofuels through the means established in its regulations. On January 1, 2007, a biofuel quota was set representing the minimum (escalating) share of biofuels which should be made available in consideration of the total annual amount of diesel and fossil gas consumed in addition to the share of biofuels. The launch of this quota, which is gradually increased, coupled with the tax exemption in force for pure biofuels used in farming, created a secure and growing market for this kind of fuel.

With the purpose of fostering energy production from renewable energies, Germany implemented a more direct and effective method than granting tax benefits. Pursuant to the law on the preferential use of renewable energies (*Gesetz für den Vorrang der Erneuerbaren Energien*), plant operators are granted a fixed compensation for electricity generation based on renewable energies. No other tax benefits are used. The latter continue to be used in isolated cases, although quite negligibly, since a tax exemption at the current applicable rates in the EC could not offset the additional costs incurred in electricity generation based, for instance, on wind or photovoltaic energy.

In previous years, numerous programs were put in place with the purpose of increasing energy efficiency in buildings. These programs fostered, for example, rehabilitation of buildings with CO_2, environmental construction and the use of renewable energies such as solar energy.

Since the beginning of 2005, Germany has imposed a toll for trucks, collected at intervals of heavy-weight trucks using highways. This

toll, applicable for vehicles with a total allowed weight of 12 t, has already been seen to have positive effects, since capacities are better utilized, and vehicles with lower emission counts are being used. The Federal Government uses the revenue from this toll to fund a related investment program to purchase heavy-weight trucks with extremely low emission levels.

On January 1, 2005, the EU adopted a system for the trade of emission rights (**emission trade**). Target emissions figures have been set, and plant operators of the sectors affected have the option of either reducing their Co_2 emissions or buying emission rights. This system enables the reduction of greenhouse gases profitably, specifically and efficiently. Thus, the trade of emissions boosts investment in technologies capable of reducing CO_2 emissions.

This system will be expanded in the future. On the one hand, starting in 2012, it shall include air traffic. On the other hand, it shall expand the scope of application of the current system of emission trade to other industrial sectors, and a significant share of the rights needed might be auctioned.

In addition to using tax instruments to promote environmentally friendly behaviors, the elimination of subsidies which are harmful to the environment should also be part of an ambitious climate policy.

To that end, effective on January 1, 2006, for example, Germany repealed the most important individual subsidy, namely the allowance on own homes, applicable on all new requests.

Prior to said date, Germany encouraged the possibility of home ownership to increase property as a safeguard for old age by subsidizing the purchase and / or construction of own homes for a period of 8 years, provided the individual's income was within a given threshhold.

Eliminating subsidies necessary in consolidating the public budget was one of the motivations. However, an additional motivation was the environmental concern. This lasting benefit, which allowed access to own housing and subsidized the building of family homes triggered an exodus toward the city and further land occupation.

III.3. Future Measures

After the European Council of Heads of State and Government under the German chair laid the foundations of the European energy and climate policy (the goal of the EU is to restrict average temperature increases to a maximum of 2 degrees as compared to the pre-industrial level) in the Spring of 2007, the Federal Government passed a package of measures in the framework of an integrated energy and climate program with the purpose of meeting these national objectives, integrating climate protection objectives and measures against increases in energy prices and those in favor of secure energy supplies.

Currently, the Federal Government is still working to achieve models which enable changes to the tax base of the motor vehicle tax, which shall be calculated in consideration of CO_2 emissions. This will encourage people to purchase motor vehicles with low emission levels.

The restructuring of the toll on trucks will strengthen the control effect of the environmental policy, while rewarding trucks emitting less harmful substances as a result of the stricter distinction.

By 2013 at the latest, an agreement shall be reached with the German industry on integrated energy management for the tax reductions granted.

This energy management system consists of a qualified energy consultant who should determine and document the existing potential in improving energy efficiency and reducing costs, in addition to establishing through which measures and at what cost it would be possible to reduce CO_2 emissions and, thus, save energy.

It is expected that, in many cases, profitable savings will be confirmed, in particular faced with the higher energy costs. It shall be up to the company to decide how to tap the potential determined by means of energy management systems.

III.4. Other Tax Measures Discussed

Taxation of air traffick

In the past – before discussions regarding the inclusion of air traffick in emission trade – Germany was traditionally in favor of taxing aircraft gasoline since, according to the tax exemptions set forth in international agreements, air traffick is currently not contributing significantly toward fighting climate change, although emissions from this transport area have been on the increase for years. At least in the European context, it has not been possible to create a tax on aircraft gas, since it would require agreement from all member States. At the moment, such consensus does not exist.

Notwithstanding, a few member States sought an alternative and created a tax on air fare or a contribution payment per passenger. Germany accepts this type of contribution, although so far no decision has been made as to whether the air fare tax will be required.

A more environmentally friendly value added tax

In view of the higher energy prices, there are frequent appeals to reducing taxation for energy inputs or establishing the foundations to promote products featuring unique energy efficiency. This could be achieved by slashing VAT rates on energy products or energy-efficient products.

However, such tax reductions do not automatically translate into price changes, since taxes are price-dependent and, in addition, they should not be recorded separately.

Thus, giving VAT an environmental orientation by setting reduced rates is arguably a good approach for Germany for the following reasons:

- As instruments of political control, reduced tax rates are rather unsuitable, since it cannot be assured that benefited products will be offered to consumers at a lower price and thus reach the desired outcome.
- Reduced tax rates should only be used when they are unmistakably more advantageous than regulatory provisions for purposes of the goal pursued.
- From the budgetary perspective, it would not be possible to expand

the scope of the reduced rate, especially because this would derive in similar appeals from other areas.

- Creating a reduced tax rate for “eco-products” would raise serious issues when it comes to setting the caps. This situation would entail significant administrative expenses and it would give businesspeople the possibility of avoiding taxes on the turnover tax.
- Creating a reduced tax rate for “eco-products” implies incurring the risk of disrupting competition.

IV. CONCLUSIONS

The discussion of the use of reduced tax rates in environmental policy shows the limits of tax control measures. These instruments need to be practical and simple, which is seldom the case in complex tax systems pursuing control purposes. It is often not possible to reach all target segments by means of tax control instruments, especially when environmental considerations are required in the framework of corporate tax provisions. In addition, there are policy issues in the area of subsidies, the tax system and (in Germany, in particular) the constitution, which are counter to the environmental nature of the tax system.

When environmental taxes are used, such as in Germany, it is often necessary to find the right balance between the environmental objectives pursued and the possible repercussions on the competitiveness of the corporations involved. Revenue collection also becomes important in this connection. Thus, excessive burdens could be offset by establishing exemptions for those affected or by eliminating other contributions. In the case of the environmental tax, a relief on the labor factor enables increased efficiency for the economy as a whole. However, care should be taken so as not to eliminate the control function expected from said taxes.

An additional issue in this context would be for the desired environmental behavior to reduce tax collection.

Given the difficulties associated with taxes, they cannot be used as the single control instrument. On the contrary, a wider approach is required which includes other aspects in addition to taxation.

All market instruments, i.e. not only environmentally relevant taxes but also the mechanisms for the trade of CO_2 emissions rights, financial

incentives for purchasing eco-friendly products or the elimination of environmentally harmful subsidies play an important role in climate policy. These mechanisms shall be completed by other elements such as investment in greener technologies, research and development, and the regulatory framework.

The decision-making driver should always be which instruments would more effectively counter harmful environmental effects.

From the German perspective, the control function of taxes in the environmental arena in the future should be subordinated to public budgets, since the most important objective of taxation is, precisely, raising these budgetary funds. For this reason, tax benefits granted to reward desired environmental behaviors should be specially harmonized with the objective of budgetary consolidation.

Likewise, it is essential to join efforts in the international sphere with a view to effectively mitigating global climate change.

As a member of the EU, Germany is integrated in a legal framework which has a very significant influence on the design of national tax systems. As mentioned earlier, such is the case of the tax harmonization for energy products within the EU. There are EC regulations on these products, which should be taxed or exempted from tax depending upon the circumstances.

The different structure of national tax systems in this framework may give rise to disruptions in the competitive scenario among member States. This leads to the need for some degree of coordination in the EU domestic market. The repercussions on competitiveness that the alternative measures may have should be reckoned with, such as the risk of relocation of CO_2 emission sources.

As a result of the different approaches in terms of climate policy arising from the various scenarios, exchanging opinions and experiences among States, such as during CIAT's Technical Conference in South Africa, becomes particularly relevant.

ANNEX

Table 1
REGULAR TAX RATES ON ENERGY PRODUCTS

	Until 3/31/1999	4/1/1999	1/1/2000	1/1/2001	11/1/2001	01/01/2002	01/01/2003
	DM (euro per 1,000 litres)					Euro per 1,000 litres	
Gasoline, unleaded Sulphur content:	**980,00** (501,07	**1.040,00** (531,74)					
>50 mg/kg			**1.100,00** (562,42)	**1.160,00** (593,10)	**1.190,00** (608,44)	**639,10**	
≤ 50 mg/kg			1.100,00 (562,42)	1.160,00 (593,10)		**623,80**	
> 10 mg/kg							**669,80**
≤ 10 mg/kg							**654,50**
Mid-range oils	**980,00** (501,07)	**1.040,00** (531,74)	**1.100,00** (562,42)	**1.160,00** (593,10)		**623,80**	**654,50**
Diesel Sulphur content:	**620,00** (317,00)	**680,00** (347,68)					
>50 mg/kg			**740,00** (378,36)	**800,00** (409,03)	**830,00** (424,37)		
≤ 50 mg/kg			**740,00** (378,36)	**800,00** (409,03)		**455,00**	
>10 mg/kg						**439,70**	**485,70**
≤ 10 mg/kg							**470,40**
	DM (euro) per megawatt-hour					Euro per megawatt-hour	
Natural Gas and other gaseous hydrocarbons	**47,60** (24,34)	**50,50** (25,82)	**53,40** (27,30)	**56,30** (28,79)		**30,30**	**31,80**
	DM (euro) per 1,000 kilograms					Euro per 1,000 kilograms	
LPG	**1.863,00** (952,54)	**1.966,60** (1.005,51)	**2.070,00** (1.085,37	**2.173,40** (1.111,24)		**1.164,10**	**1.217,00**
						Effective on 08/01/2006: euro per gigajoule	
Carbons and oil coke (used in homes, not taxed until 12/31/2010)							**0,33**
DM (euro) per megawatt-hour					Euro per megawatt-hour		
Electricity		20,22 (10,23)	25,00 (12,78)	30,00 (15,34)	17,90	20,50	20,50

Table 2
REBATES AND OFFSTES OF THE HYDROCARBONS TAX FOR GIVEN BUSINESS SECTORS

		Light fuel-oil 1,000 litres	**Natural gas** 1 megawatt-hour	**LPG** 1,000 kilograms
Manufacturing, farming and forestry businesses performing combustion to obtain heat for business purposes or in plants receiving the benefit under Section 3 of the EnergieStG Law.	**until 12/31/2001**	32,00 DM (16,36 euros)	2,56 DM (1,308 euros)	20,00 DM (10,22 euros)
	Effective on 01/01/2002:	16,36 euros	1,308 euros	10,22 euros
	Effective on 01/01/2003:	8,18 euros	1,464 euros	14,02 euros
	Effective on 01/01/2007:	16,36 euros	2,20 euros	24,24 euros

Electricity (per megawatt-hour)					
04/01/1999	**01/01/2000**	**01/01/2001**	**01/01/2002**	**01/01/2003**	**01/01/2004**
4,00 (2,05)	**5,00** (2,56)	**6,00** (3,07)	**3,60**	**12,30**	**12,30**

Table 3
REDUCED TAX RATES

	Until 3/31/1999	**4/1/1999**	**1/1/2000**	**1/1/2001**	**1/1/2002**	**1/1/2003**	**1/1/2004**
Fuels	DM (euro) per 1,000 kilograms				Euro per 1,000 kilograms		
LPG, unmixed with other mineral oils until 12/31/2018	**241,00** (123,22)	**255,70** (130,74)	**270,50** (138,30)	**285,30** (145,87)	**153,40**	**161,00**	**180,32**
	DM (euro) per megawatt-hour					Euro per megawatt-hour	
Natural gas and other hydrocarbons until 12/31/2018	**18,70** (9,56)	**19,80** (10,12)	**20,90** (10,69)	**22,00** (11,25)	**11,80**	**12,40**	**13,90**
Solid fuels	DM (euro) per 1,000 litres					Euro per 1,000 litres	
Light fuel-oil	**80,00** (40,90)	**120,00** (61,36)	**120,00** (61,36)	**120,00** (61,36)	**61,35**	**61,35**	**61,35**
Heavy fuel-oil			**35,00** (17,90)	**35,00** (17,90)	**17,89**	**25,00**	**25,00**
For thermal generation (until 12/31/1999)	**30,00** (15,34)	**30,00** (15,34)					
For electrical generation (until 12/31/1999)	**55,00** (28,12)	**55,00** (28,12)					
	DM (euro) per 1,000 kilograms					Euro per 1,000 kilograms	
LPG (combustion for heat)	**50,00** (25,56)	**75,00** (38,35)	**75,00** (38,35)	**75,00** (38,35)	**38,34**	**60,60**	**60,60**
	DM (euro) per megawatt-hour					Euro per megawatt-hour	
Natural gas (combustion for heat)	**3,60** (1,84)	**6,80** (3,48)	**6,80** (3,48)	**6,80** (3,48)	**3,476**	**5,50**	**5,50**

Gas oil – Offset for farming and forestry businesses (no offset if the amount of these is lower than 50 euros per year) Effective on 01/01/2005: Deduction of 350 euros and benefit cap of 10,000 litres per year per company	**01/01/2001**	**01/01/2002**	**01/01/2003**
	DM (euro) per 1,000 litres	Euro per 1,000 litres	
	300,00 (153,39)	**184,10**	**214,80**

Table 3 Cont'd
REDUCED TAX RATES

		Light fuel-oil 1,000 litres	**Heavy fuel-oil** 1,000 litres	**Natural gas** 1 megawatt-hour	**LPG** 1,000 kilograms
Co-generation installations with a minimum degree of monthly or annual usage of 70	**Until 12/31/2001**	120,00 DM (61,35 euros)	35,00 DM (17,89 euros)	6,80 DM (3,476 euros)	75,00 DM (38,34 euros)
	Effective on 01/01/2002:	61,35 euros	17,89 euros	3,476 euros	38,34 euros
	Effective on 01/01/2003:	61,35 euros	25,00 euros	5,50 euros	60,60 euros

Rebate and offset of the hydrocarbons tax for public passenger transportation					
	1/1/2000	**1/1/2001**	**1/1/2002**	**1/1/2003**	**1/1/2004**
	DM (euro) per 1,000 litres		Euro per 1,000 litres		
Gas and diesel	**30,00** (15,34)	**60,00** (30,68)	**46,05**	**61,40**	**54,02**
	Euro per 1,000 kilograms		Euro per 1,000 kilograms		
LPG	**7,40** (3,78)	**14,80** (7,57)	**11,40**	**15,20**	**13,37**
	Euro per megawatt-hour		Euro per megawatt-hour		
Natural gas	**0,55** (0,28)	**1,10** (0,56)	**0,85**	**1,15**	**1,00**

	DM (euro) per megawatt-hour			**Euro per megawatt-hour**		
Electricity (Transport with trolleybuses or during the operation of rail transport except for internal business transportation and funiculars)	**10,00** (5,11)	**12,50** (6,39)	**15,00** (7,67)	**9,00**	**10,20**	**11,42**

Electricity produced from renewable energies	Totally tax exempt, provided it is obtained exclusively from a grid supplied by renewable energy resources

Case study

Topic 1.1

ENVIRONMENTAL PROTECTION TAX MEASURES

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CONTENTS: 1. Introduction.- 2. Overview of 'green' taxes in the Netherlands.- 2.1. Environmental taxes.- 2.1.1. Tax on groundwater.- 2.1.2. Tax on tap water. 2.1.3. Tax on waste.- 2.1.4. Coal tax.- 2.1.5. Energy tax. - 2.1.6. Air passenger tax.- 2.1.7. Packaging tax.- 2.2. Excise duty on mineral oils.- 2.3. Taxes on motor vehicles.- 2.3.1. Car registration tax.- 2.3.2. Annual circulation tax.- 2.3.3. Tax on heavy goods vehicles.- 2.4. Revenues of green taxes.- 3. Why fiscal greening?.- 4. Green incentives.- 5. Lessons derived from our experience.- 6. Environmental effects.- 7. Green taxes and tax administration.- 7.1. Environmental taxes.- 7.2. Excise duty on mineral oils.- 7.3. Taxes on motor vehicles

1. INTRODUCTION

First of all we will give you an overview of the present 'green' taxes in the Netherlands (chapter 2). The arguments used to support the 'greening' of the tax system will be discussed in chapter 3. In chapter 4, we will briefly discuss the use of the tax instrument to promote environmentally friendly behaviour. The lessons we derived from greening of our tax system over the last 20 years in the Netherlands are the subject of chapter 5. In chapter 6 we briefly discuss the environmental effects of green taxes. The methods of levying green taxes are the subject of chapter 7.

2. OVERVIEW OF 'GREEN' TAXES IN THE NETHERLANDS

Ever since the nineties, environmental taxes have gained importance within the Dutch tax system. This process is also known as fiscal greening. In chapter 3 we will discuss the factors which played an important part in this process.

Environmental taxes are defined as compulsory payments to the government, levied on tax bases deemed to be of particular environmental relevance, without the government having to deliver a service in return[1]. Revenues of environmental taxes need not be spent on environmental objectives. In the Netherlands, all revenues of taxes end up with the National Treasury (including those of environmental taxes). The government then determines on which objectives (including environmental ones) they want to spend the money.

'Green' taxes can be divided into the following three categories:

a. environmental taxes (par. 2.1)
b. excise duty on mineral oils (par. 2.2)
c. taxes on motor vehicles (par. 2.3)

The revenues of these taxes are listed in par. 2.4.

2.1. Environmental Taxes

The following environmental taxes are levied in the Netherlands as part of the
Environmental Taxes Act: groundwater tax, tap water tax, waste tax, coal tax, energy tax, packaging tax and air passenger tax.

2.1.1 Tax on Groundwater

Groundwater tax is levied on all water that is extracted from the ground. The environmental argument for this tax is to discourage the extraction of groundwater and promote economical use of supplies which are subject to depletion.

Groundwater tax is payable by the companies that extract groundwater; for example, waterworks, farms, drainage contractors and manufacturing companies that use groundwater, e.g. as cooling water or processing water.

The amount of tax payable is calculated on the basis of the number of cubic metres of groundwater extracted by the company. The rate is € 0.1883 a cubic meter.

[1] *See OESO (2006), The Political Economy of Environmentally Related Taxes, page 26.*

2.1.2. Tax on Tap Water

A business or a household with a connection to the water supply system pays tax over a quantity of, at maximum, 300 cubic metres a year for each connection. The environmental argument for this tax is to promote the economical use of tap water.

Taxes are collected by the supplier (the water company), who passes them on to the Tax Administration.
The rate is € 0.151 a cubic meter.

2.1.3. Tax on Waste

Tax on waste is levied on waste that is dumped. The environmental argument for this tax is to promote the processing of waste in the best possible way from an environmental point of view. Recycling or prevention is preferred, dumping is the least desirable option.

Waste-processing plants are liable to pay tax. They have to pay tax on the tonnage of waste they receive to dump on their site.

The rate is € 88.21 for each 1,000 kilos of landfilled waste.

A lower rate applies to landfilling with non-flammable waste and to waste that should preferably not be incinerated (for instance, from an environmental point of view). This rate is € 14.56 for each 1,000 kilos.

2.1.4. Coal Tax

The environmental argument for this tax is to tackle pollution and to reduce energy consumption.

Coal tax is mainly levied on coal importers, who use the coal themselves or deliver the coal to other users (e.g. power stations). The rate is € 12.95 a 1,000 kilos of coal.

Coal tax does not have to be paid for coal that is used to generate electricity, under certain conditions. The main reason for this exemption is that electricity is taxed with energy tax; without an exemption for coal tax there would be double taxation.

2.1.5. Energy Tax

The environmental argument behind this tax is reduction of CO_2-emissions and energy consumption. Energy tax is a tax on natural gas, electricity and some mineral oils (kerosene, gas oil and LPG) that can be used as substitutes for natural gas.

In principle, suppliers of energy are designated as tax-payers. A supplier of energy will subsequently pass on the energy tax to those who use energy.

The tax rates are related to the quantities used. Part of the energy consumption is regarded as a basic requirement. The tax is therefore reduced by a sum of € 199 a year, for each connection to the electricity grid.

Electricity	**Rates**
0 - 10,000 kWh	€ 0.0752 a kWh
10,000 - 50,000 kWh	€ 0.0375 a kWh
50,000 - 10 m kWh	€ 0.0104 a kWh
50,000 - 10 m kWh	€ 0.0104 a kWh
over 10 m kWh	- € 0.0005 a kWh for business use - € 0.0010 a kWh for non-business use
Natural gas	**Rates**
0 - 5,000 m3	€ 0.1554 a m3
5,000 - 170,000 m3	€ 0.1362 a m3
170,000 - 1 million m3	€ 0.0378 a m3
1 million - 10 million m3	€ 0.0120 a m3
over 10 million m3	- € 0.0079 a m3 for business use - € 0.0112 a m3 for non-business use

There are a number of exemptions for energy tax. Under certain conditions, an exemption applies, for instance if natural gas is used as fuel for generating electricity. Exemption also applies to business-related use of electricity in so far as such use exceeds 10 million kWh, provided the user has agreed to the obligations for improving energy efficiency within the framework of agreements with the central government and provided the user has been designated as an energy-intensive business.

2.1.6. Air Passenger Tax

This tax was introduced on 1 July 2008. Air traffic has a harmful impact on the environment that is not reflected in market prices. Ideally, kerosene would be subject to excise duty. However, air traffic is almost exempt from taxation, mostly due to international treaties. Therefore, the Netherlands decided to introduce an air passenger tax.

This tax is levied on each out-going passenger. Transfer passengers are exempt from this tax.
The tax is levied on airport proprietors.

Rates are differentiated according to destination. The rate is € 11.25 for destinations situated within Member States of the European Union (excluding the so-called ultra-peripheral areas, such as the Canary Islands, the Azores and Madeira) or distances up to 2500 kilometres. The tax rate is € 45 for all other destinations.

2.1.7. Packaging Tax

This tax was introduced on 1 January 2008. The environmental argument for this tax is to allow the degree of environmental pollution to be expressed in the market price. Additionally, it is aimed at reducing packaging quantities and achieving a shift to the use of different packaging materials.

Manufacturers and importers of the packaging, or rather the products they were used for, are liable to pay the tax. A tax threshold of 15,000 kg applies to each taxpayer. Packaging tax will only be paid on quantities that exceed the threshold. This means that the tax will not affect businesses that provide less than 15,000 kg of packaging.

Eight types of packaging materials are defined: glass, aluminium, others metals, plastic, biodegradable plastic, paper/cardboard, wood and other types of material. Rates have been fixed for each type of material, depending on the pressure they place on the environment. The rate for primary packaging (the packaging on the product being sold) is higher than for secondary/tertiary packaging (packaging required to keep various sales units together and to protect products during transportation). For compound materials, the individual types of materials used must be indicated.

The following rates apply in 2008 for each kilo of packaging material:

Type of material	Primary packaging	Secondary/tertiary packaging
Aluminium	€ 0.5731	€ 0.2011
Plastic	€ 0.3554	€ 0.1247
Biodegradable plastics	€ 0.1777	€ 0.0624
Other metals	€ 0.1126	€ 0.0395
Other materials	€ 0.1017	€ 0.0357
Paper and cardboard	€ 0.0641	€ 0.0225
Glass	€ 0.0456	€ 0.0160
Wood	€ 0.0228	€ 0.0080

2.2. Excise Duty on Mineral Oils

Excise duty is a tax levied on alcoholic beverages, tobacco products and mineral oils, such as petrol, diesel, domestic fuel oil and LPG. Similar to VAT, excise duty is included in the consumer price. The tax is remitted to the Tax Administration by manufacturers in the Netherlands, by traders and also by importers of mineral oils.

These excise duties were introduced many decades ago, primarily as a means to raise revenue. Regardless of this aspect, they have an impact on the prices of fuels, just like ‘real’ environmental taxes. Therefore, excise duties on mineral oils may be regarded as environmental taxes.[2]

2.3. Taxes on Motor Vehicles

Three types of taxes apply to motor vehicles:

- car registration tax (par. 2.3.1)
- annual circulation tax (par. 2.3.2)
- tax on heavy goods vehicles (par. 2.3.3)

As for excise duties on motor fuels, taxes on motor vehicles were introduced many years ago, primarily in order to raise revenue. These taxes also have a positive impact on the environment and may be regarded as environmental taxes.

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[2] *See OESO (2006), The Political Economy of Environmentally Related Taxes, page. 30: about 90% of the revenues from environmentally related taxes are raised on motor fuels and motor vehicles.*

2.3.1. Car Registration Tax

The car registration tax is levied on passenger cars and motorcycles. It is paid once for each vehicle at the time of registration or first use on the Dutch roads. If the passenger car is new, the importer pays the tax on behalf of the buyer. A person importing a used passenger car or motorcycle must pay the tax himself.

• Passenger cars

The rate for new petrol-driven passenger cars is 42.33% of the net catalogue price less € 1,442. For diesel-powered passenger cars the rate is 42.33% of the net catalogue price plus € 307.

• Motorcycles

The rate for motorcycles is 9.66% of the net catalogue price up to a net price of € 2,133 and 19.44% of the net catalogue price less € 210 above € 2,133.

• Environmental differentiation

The car registration tax takes the environmental performance (CO_2-emission) of the passenger car into account. A tax reduction applies to cars that use less fuel when compared to other cars in their category, while cars that use more fuel, comparatively, are subject to a tax raise.

By means of a labelling system cars are designated to be either environmentally friendly or not. Environmentally friendly cars obtain an A-label and are awarded a discount on the car registration tax to be paid. Labels run up to and include G (the most environmentally unfriendly car) which is awarded with a raise instead of a discount.

As of 1 February 2008 a surcharge applies to cars with high fuel consumption. For a petrol-driven car that emits over 232 grams of CO_2 a kilometre, the tax is increased. The increase is € 110 for every gram of CO_2 over and above 232 grams a kilometre. Although the same applies to diesel-driven cars, this threshold is lower, 192 gram a kilometre.

As of 1 April 2008, there is a special regulation for diesel-driven cars. The tax is increased or reduced in accordance with the emission of particulate matter.

2.3.2. Annual Circulation Tax

Persons with a passenger car, van, motorcycle or lorry registered in their name, are subject to the annual circulation tax.

The amount of tax payable depends on:
- type of vehicle (passenger car, van, motorcycle, lorry, bus);
- vehicle weight;
- fuel type of passenger cars (petrol, diesel, lpg);
- CO_2-emissions of extremely economical passenger cars.

2.3.3. Tax on Heavy Goods Vehicles

This tax, also known as the Eurovignette, is payable for heavy goods vehicles making use of the motorways. A heavy goods vehicle is a lorry used solely for the road haulage of goods, with a maximum authorised weight over and above 12 tonnes. This tax is based on a treaty between the Netherlands, Belgium, Luxembourg, Sweden and Denmark. It is payable a day, week, month or year, or a combination of these. The amount depends on the total number of axles of the vehicle and its Euro classification (euro-0, euro-1, euro-2 or cleaner).

The tax has to be paid in advance and the Eurovignette must be carried in the vehicle. Anyone buying a Eurovignette in one of the countries that applies the Eurovignette, is allowed to use the motorways in all member countries of the treaty.

2.4. Revenues of Green Taxes

The table below lists an overview of the revenues for each type of taxes in 2007. The total revenue of green taxes was 17.2 billion Euros. When expressed as a percentage of the total tax revenues (excluding social security contributions) this amounts to approximately 13%.

Air passenger tax and packaging tax entered into force in 2008. The estimated revenue for 2009 of air passenger tax is 350 million Euros; and 365 million Euros for packaging tax.

Green taxes	Revenue 2007 (millions of euros)
A. Environmental taxes:	
Tax on groundwater	184
Tax on tap water	125
Tax on waste	172
Coal tax	1
Energy tax	3,373
B. Excise duty on mineral oils	6,943
C. Taxes on motor vehicles	
Car registration tax	3,603
Annual circulation tax	2,766
Tax on heavy goods vehicles	115
Total revenue green taxes	**17,282**

3. WHY FISCAL GREENING?

There are five key arguments in favour of greening the tax system:

- **The polluter pays**
  One of the reasons for the frequent use of environmental taxes in the tax structure is a changing sense of justice as to who should pay taxes. There is an ever increasing political desire to make a larger amount of taxes payable by those who cause pollution. This coincides with the principle that polluters should pay. This principle is supported throughout the European Member States and is therefore entered into Article 174 of the EG Treaty on the environmental policy of the European Union.

- **Internalisation of environmental costs Environmental costs caused by specific actions are** by no means always expressed in the price of such actions. We call this market failure. In such cases environmental costs are paid by the government and, therefore, indirectly by all taxpayers. By means of levying taxes these environmental costs can still (partly) be charged to the actual polluters. As such, environmental costs are incorporated in the price; as it were, they are internalised in the price. In effect, such levies need not disturb the market, but may rather promote the optimal allocation of scarce resources.

- **A broad, robust and well-balanced tax basis**
  The primary goal of levying taxes is obtaining public funds. In this respect, it is very important to have a broad and stable tax basis. Fist of all, the levying of taxes becomes more broadly-based by adding environmental taxes to the tax structure. Secondly, it is often quite easy to collect indirect taxes (such as environmental taxes), when compared to direct taxes, such as those levied on labour and profits. Moreover, they are more difficult to avoid and display a more stable pattern of revenues.

- **Shifting the tax burden**
  Greening the tax system in the Netherlands did not only involve broadening the tax basis, but also a shift from direct to indirect taxes. To compensate for the revenues of environmental taxes, other taxes, for instance taxes on labour or profit, were decreased. In effect, this is shifting the tax burden. Theoretically, such a shift of the tax burden may have positive effects on the Dutch business environment, the demand for labour (as labour costs are decreasing) and may eventually lead to extra economic growth. This is the reason why a shift of the tax burden by means of increased environmental taxes and decreased labour and profit taxes is also known as the 'double-edged sword'. On the one hand the environment improves and on the other hand the economy grows. There is, however, some difference of opinion in economic literature as to whether this 'double-edged sword' has actually been effective in respect of fiscal greening.

- **Positive fiscal incentives**
  Taxation may be deployed to charge environmentally unfriendly behaviour and to reward environmentally friendly behaviour. In this respect, we generally mean positive incentives which are used to achieve environmental objectives (see chapter 4). However, history teaches us that fiscal incentives do not always achieve the desired effect, because of their generic character, and that the desired behaviour might have occurred anyway, irregardless of the presence of a fiscal facility.

4. GREEN INCENTIVES

In the Netherlands, taxation is not only used for charging environmentally polluting behaviour, but also for promoting environmentally friendly behaviour. This is known as the use of green incentives. The Dutch tax system uses various green incentives.

Some examples:

- **Energy Investment Deduction (EIA)**
  The EIA offers an extra deduction on profit for investments in energy saving techniques and applications of sustainable energy. This deduction amounts to 44% of the invested sum. A list of investments which qualify for the EIA is compiled annually.

- **Environmental Investment Deduction (MIA)**
  The MIA offers an extra deduction on profit for investments in environmentally friendly company assets. Similar to the EIA the MIA applies to a list of designated investments. This deduction amounts to a maximum of 40% of the invested sum.

- **Green investments**
  The scheme 'Green Investments' offers an exemption of income tax for income from investments in designated funds, which comply with a green investment profile.

- **Environmentally differentiated rates**
  Within a type of tax the rates may be differentiated and environmentally friendly behaviour may be taxed at a lower rate. The car registration tax (see par. 2.3.1) is an example of environmentally differentiated rates.

5. LESSONS DERIVED FROM OUR EXPERIENCE

We will further discuss the lessons we have derived from our experience with environmental taxes in the Netherlands. These lessons may be helpful in designing and introducing environmental taxes.

Taxation objective in contrast with environmental objective?

There seems to be a dilemma with regard to environmental taxes. On the one hand, taxation policy demands stable tax revenue. On the other hand, environmental policy aims at altering harmful behaviour and possibly, eventually, preventing such behaviour. The latter would imply that tax revenue slowly decreases and even runs dry. There is, however, no need for the taxation objective to be in contrast with the environmental objective. It is possible to find a sufficient number of environmental bases that will not just run dry, like energy consumption or air traffic. Environmental costs, which are not expressed in the price, are incorporated by taxing these bases. Consequently, people

will incorporate the environmental costs in their behavioural pattern. Environmentally friendly behaviour will be rewarded, as the tax charges are lower. Research shows that this is how the energy tax in the Netherlands accounts for a decrease of energy consumption by 3,5% when compared to a situation without energy tax. At the same time, the energy tax offers stable tax revenues of approximately 4 billion Euros. The final environmental effect of an environmental tax may be limited, but even then it is preferable to tax environmentally polluting behaviour. After all, revenues of environmental taxes may be used to decrease other taxes.

Shifting tax basis

A second lesson is the fact that it was very important in the Netherlands that environmental taxes were used to decrease other taxes. In other words: the tax basis has shifted. The total tax revenue remained the same in this process; taxes on income and profit have decreased, whilst taxes on environmentally unfriendly behaviour have increased. As such, labour costs in the Netherlands dropped. This shift in taxes created public support.

Public support

Whenever a new tax is introduced, it is essential to have public support. That is the reason why the Dutch government has always investigated how the tool of environmental taxes may be deployed to achieve a better environment. They have done so in close cooperation with representatives of environmental organisations, representatives of employers and employees and independent experts. This requires a lot of consultation, but assures that all voices will be heard. Consequently, all interests can be taken into account, which enlarges the amount of public support. In the Netherlands, it proved to be very convenient to design new policies together with independent research institutions. These institutions have calculated the economic and environmental effects of new government plans, thus assuring that the political decision process is based on independent figures.

Small steps

Greening the tax system is most likely to succeed if the process in executed by taking small steps at a time. Alternatively, social opposition might become too strong. It is therefore advisable to start by taking simple measures and not immediately aim at raising high tax revenues. In the future, these measures may be refined, for instance by differentiating the rates based on environmental characteristics. The

revenues may also be gradually increased over the years. A shift from taxes on labour and income to environmental taxes may be achieved within a few years' time.

Feasibility and administrative burden

The fifth lesson is about the feasibility and the administrative burden of environmental taxes. Questions must be answered on the following subjects: is this tax feasible, which measures must be taken by the Tax Administration to implement this tax and which implementation costs will arise from this measure?

When designing new taxes, the Netherlands aim at keeping the number of taxpayers as low as possible. In this way, we are not just limiting the administrative burden but also the implementation costs. In the Netherlands, we attach great importance to low administration costs and implementation costs, which is shown by the fact that the Tax and Customs Administration is involved in the development of policy plans at an early stage.

Positive incentives

When discussing environmental taxes, the primary view is on introducing new taxes. Environmentally polluting behaviour must be charged heavier. However, this is not the only way to use the tax instrument for environmental policies. Instead of charging polluting behaviour heavier, it is also possible to promote environmentally friendly behaviour. In this respect, positive incentives, or tax credits, may be introduced. In the Netherlands, we offer tax credits for investments in environmentally friendly techniques and for investments resulting in energy saving (see chapter 4).

6. ENVIRONMENTAL EFFECTS

Just like in many other countries, tax differentiation between leaded and unleaded petrol led to a strong fall in the market share of leaded petrol, which is now withdrawn from sale. A differentiation in the car registration tax in order to give an incentive for cars with a catalytic converter, was also successful. In recent years, differentiation of excise duty rates on diesel according to the sulphur content of the fuel led to a very quick response of the oil industry. Supply has very rapidly shifted from high-sulphur to low sulphur diesel.

A well-known problem of evaluating the environmental effects of environmental taxes is that these taxes are generally applied together with other instruments (such as regulations, product standards, information campaigns, voluntary agreements), which makes it difficult to isolate the impact of a tax.

A lot of research was done on the environmental effects of energy tax, both before and after implementation. Ex ante studies show a distinct impact on energy consumption based on available price elasticity estimates. Ex post data on environmental effectiveness are still relatively scarce. This is not only due to the fact that there is a shortage of data and practice when it comes to policy evaluation, but also because energy prices are determined by other factors than energy tax and because energy consumption is influenced by more factors besides pricing.

7. GREEN TAXES AND TAX ADMINISTRATION

When designing environmental taxes, the Netherlands aim at keeping the number of taxpayers as low as possible. That is why energy taxes are not levied on end users, but on energy companies, in the Netherlands. Waste-processing plants are liable to pay the tax on waste. Excise duty on mineral oils is levied on a limited number of oil refineries and depots. Most car registration taxes are levied on car importers. As such, these taxes are rather simple to administer and enforce. The annual circulation tax, however, is a tax involving a large number of tax payers, because everybody who has a motor vehicle registered in his name, is liable to pay this tax.

We will briefly discuss the way the different taxes are levied.

7.1. Environmental taxes

Groundwater tax, tax on tap water, tax on waste, coal tax, energy tax, air passenger tax and packaging tax are all assessed on the basis of tax returns. The taxpayer is obliged to file a tax return for each tax category using the prescribed tax return form. This is generally sent automatically by the Tax Administration. If this is not the case, the taxpayer must request the form himself.

Tax returns for environmental taxes may be filed monthly, quarterly or annually. The return must be filed with the Tax Administration within one month of the end of the period of assessment and the payment

must be credited to the Tax Administration's account within that month as well.

If a taxpayer is late in filing his return or is late in making payment, he risks a fine. The Tax Administration checks afterwards on the basis of the taxpayer's administration whether the correct amounts were declared and paid.

7.2. Excise duty on mineral oils

The system is the same as for the environmental taxes.

7.3. Taxes on motor vehicles

- car registration tax

If the passenger car is new, the importer pays the tax on behalf of the buyer. A person importing a used passenger car or motorcycle must pay the tax himself.

- annual circulation tax.

People who have a passenger car, van, motorcycle or lorry registered in their name are subject to the annual circulation tax. Therefore, the obligation to pay taxes is linked to the license plate registration and not to road use.

- tax on heavy goods vehicles

The tax has to be paid in advance and the Eurovignette must be carried in the vehicle.

Case study

Topic 1.2

TAXATION AND INVESTMENT PROMOTION

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(IDB)

CONTENTS: I. Introduction.- II. The rise and fall and rise of tax incentives.- III. Objectives and instruments.- IV. Double taxation and the treatment of foreign income.- V. Free zones and job creation VI. Lack of success of investment tax incentives.- VII. Incentive administration and credibility of the tax regime.- VIII. Tax Expenditures.- IX. Globalization, trade agreements and investment promotion

"Tax exemption is like a dessert; it is good to have, but it does not help very much if the meal is not there"[2]

I. INTRODUCTION

Most countries, and not only the developing ones make extensive use of tax policy instruments to attract investments, promote industrial and technological development and create jobs. Nevertheless, the actual effect of tax incentives on business activities and behavior is still a matter of extensive debate[3]. Many technical studies have highlighted the limitations of tax instruments but most policymakers are reluctant to accept the possibility that tax incentives usually have little effect on ultimate business decisions. Yet taxes do matter to business and influence investment decisions. When taxation is not sound it hurts the business climate and hampers economic activities. Since the primary intent of tax incentives is to encourage capital accumulation in specific activities or locations, the question remains open if their extensive use will result in the desired response.

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1 *Economist of the Fiscal and Municipal Management Division, Institutional Capacity and Finance Department of the Inter-American Development Bank – IDB.*
2 *Words of one investor in a survey conducted by Aharoni and published in his book in 1966.*
3 *Shah, Anwar (ed.) 1995. "Fiscal Incentives for Investment and Innovation." Oxford University Press.*

A thorough survey[4] of 75 studies conducted in the US on the role of taxation by state and local governments on economic development, namely of employment growth, investment growth and firm location, concludes that taxes usually have a small effect on firm behavior. According to this survey the median interregional elasticity of economic activity with respect to taxes of 38 studies conducted in the past present medians clustering around –0.1, which means that 10% lower taxes would raise employment, investment or firm births by 1%. However, intraregional studies produce tax elasticities that are quadruple or more of those found in the interregional studies. The reason may be that the smaller the area over which a business is choosing a location, the more similar the non-tax factors are, and hence taxes would matter more.

II. THE RISE AND FALL AND RISE OF TAX INCENTIVES

According to Morisset and Pirnia[5], this view of the limited impact of tax incentives on investment decisions has been a consistent vision for some time now. A survey of 247 investors conducted in 1955 showed that for only 10% of the companies favorable taxes was a condition for FDI. They also mention that a survey of 52 multinational companies conducted in 1984 by the Group of Thirty found that among 19 factors that were identified as influencing FDI flows, inducements offered by the host country rank seventh in importance for investment in developing countries and eight in industrialized countries.

In the international context, taxes are secondary elements in the attraction of investments, following more relevant factors like market size, presence of competitors, access to raw materials, availability of skilled or cheap labor, political and macroeconomic stability and the rule of law. To prospective investors the general features of the tax system (tax base, tax rates, etc.) are more important than tax incentives. Taxpayers expect to predict the tax consequences of their actions, which require clear and stable laws.

However, as a result of increasing economic integration, particularly regional trade agreements, tax incentives are becoming a decision factor of growing importance for FDI location. Regional economic integration tends to develop more homogeneous regional markets,

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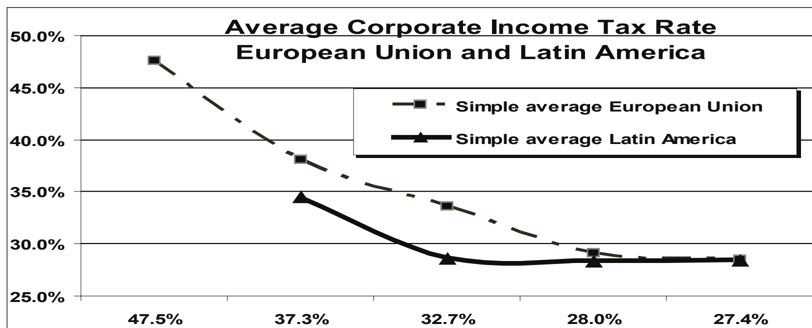
[4] *Wasylenko, Michael. 1997. "Taxation and Economic Development: The State of the Economic Literature." New England Economic Review, March/April, pp. 37-52.*

[5] *Morriset, Jacques and Pirnia, Neda "How Tax Policy and Incentives Affect Foreign Direct Investment". Policy Research Working Paper 2509, FIAS, The World Bank, December, 2000.*

and as non-tax factors become more similar, taxes will matter more to the final location decision. As pointed out by Richard Bird, "with freer international trade regimes and freer international financial markets, fiscal differences now matter more"[6]

Even further, the more integrated the economies the more relevant the tax differentials. In the European Union, where trade policy is homogeneous, monetary and exchange rate policy is common –the Euro or aligned to it— tax competition expresses clearly in the reduction of the corporate income tax rate.



Source: OECD

According to Avi-Yonah[7], tax competition is on the rise. The competition for inbound investments has led an increasing number of countries to offer tax holidays specifically geared to foreign corporate investors. Given the relative ease with which an integrated multinational in manufacturing / assembling sectors can shift production facilities in response to attractive rates such as those in production tax havens enables these companies to derive most of their income abroad free of host-country tax.

The tax environment of the host country and how it interacts with the tax provisions of the home country will have direct effects on how firms structure themselves and do business abroad. The tax treatment of technical assistance, assignments rights, use of patents and technology transfer, copyright royalties, and even of expatriate employees' income

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[6] *Bird, Richard "Tax Incentives for Foreign Investment in Latin America and the Caribbean" in "Taxation and Latin America Integration", Tanzi, Vito, Barrix, Alberto, and Villela, Luiz (eds), Harvard university and Inter-American Development Bank, 2008.*

[7] *Avi-Yonah, Reuven "Globalization and Tax Competition: Implications for Developing Countries" in "Taxation and Latin America Integration", op. cit.*

working for MNEs have great influence in shaping FDI. The same holds when there are differentiated withholding tax treatments for interest payments on debt securities or bank loans obtained abroad, for instance. Since taxes constitute a cost component, firms will always try to reduce them in order to increase competitiveness and maximize net gains. Governments know that, and many times face a dilemma since they need tax revenues but have other considerations in their agenda as well.

As observed by Keen and Simone[8], a large variety of tax incentives currently found in developing countries is not only greater than the ones currently found in developed countries but have also become more commonly used than they we a decade or so ago. As Bird[9] points out "in the course of the last two centuries, economists have not managed to persuade most policymakers that unilateral free trade policy trumps protectionist interventionism. They should not be surprised at the continued strength of such arguments with respect to attracting foreign investment" After all, policymakers are human and in democracies they are always driven to do something rather than nothing. And a "good way to appear to be doing something about providing jobs and encouraging growth is to offer incentives for such good things". And presently, with freer trade regimes and financial markets, fiscal differences now matter more.

III. OBJECTIVES AND INSTRUMENTS

Countries differ in their commercial and regulatory powers, market size, natural endowment, human capital and infrastructure, and many times tend to justify the provision of tax incentives as a counterweight to existing investment disincentives and to offset disadvantages that investors may face. If this is really the case, the most appropriate solution would be to reform the existing laws and regulations, build the necessary administrative capacities and infrastructure. As for market size and natural endowments, no tax incentives could significantly offset existing disadvantages.

Tax incentives can be defined as those provisions in tax legislation that give privileged treatment to some activities, assets, forms of organization or financing. Governments provide them in order to

[8] *Keen, Michael, and Alejandro Simone. 2004. "Is Tax Competition Harming Developing Countries More Than Developed?" Tax Notes International [Special Supplement] 34 (13): 1317-26*

[9] *Bird, Richard. Op. cit.*

encourage specific enterprises or categories of enterprises to behave in a certain manner. They act by either increasing the rate of return of a particular investment or by reducing its costs or risks. The ultimate objective is to promote additional investments that will increase income and create jobs. However, from the economic standpoint, the incentives should not affect the precedence of the different investments (Harberger neutrality).

Since development tends to be unevenly distributed, countries often employ tax incentives to channel investment to foster economic development in certain regions, by creating differential treatment in comparison to the tax treatment prevailing in other regions. The same holds for economic sectors, especially for industries and activities considered crucial for development. Most of the time they relate to investment in manufacturing, exploration or extraction of minerals, promotion of exports or tourism. Incentives can also be used to attract investment that will favor the transfer of technology, R&D (research and development) and pioneer industries.

According to an extensive survey[10] of tax incentive regimes in 45 countries from all regions of the world, nearly all had incentives targeting specific sectors, over 90% offered some type of export-oriented incentive and 70% had regional incentives targeting rural or underdeveloped areas. The types of incentive most extensively used are tax holidays or tax rate reductions, offered by 85% of the countries.

Most governments actively promote their countries as investment locations to attract FDI. The fundamental premise behind this behavior is that foreign investment creates more value for the host country than for the foreign investor. That may be so because FDI involves more than the mere flow of capital, but also the application of intangible assets such as technology and managerial expertise. If these intangible assets were completely internalized, they would be fully captured by the rate of return of the investments, and tax incentives would not be justified. But since there are spillover effects, free ridership will occur and these intangible assets will end up benefiting other sectors of the host economy, and that would justify the tax incentives.

[10] *UNCTAD. 2000. "Tax Incentives and Foreign Direct Investment: a Global Survey." United Nations, New York and Geneva.*

Tax incentives can be profit or income-based and focused to reward capital investment or labor-related expenditures. The tax benefits can be given in exchange for sales, job placements, value-added, import substitution or export targets.

Tax holidays are the most common form of tax incentives. Under this modality of incentive, eligible newly established firms are exempt from paying corporate income tax for a specified time period. However most new enterprises usually do not produce positive net income in the first years. If the losses incurred in the holiday period are not allowed to be carried forward to compensate future profits, the incentive may be useless.

A more effective way of lowering the tax burden is by artificially reducing the companies' net revenues and not the nominal tax rates. One mechanism often used is to permit investors to carry losses forward (or backward) for a significant number of years. Accelerated depreciation also allows investors to reduce taxable revenues as a result of investments, and this is very important to a firm's cash flow in the years they are paying debt associated with the investments. In some countries direct investment allowances are granted as deductions against taxable income (enhanced deduction), usually as multiples of the actual capital cost. But the ultimate result of all these incentives depends on the applicable corporate income tax rate, and for that reason they are frequently granted together with tax rate reductions or are provided not as deductions (allowances) but as investment tax credits. Another form of incentive to attract FDI is the use of reduced taxes on remittances of dividends or of interest abroad. The latter reduces financing costs and attracts foreign savings but the former could eventually stimulate the repatriation instead of reinvestment of capital.

IV. DOUBLE TAXATION AND THE TREATMENT OF FOREIGN INCOME

In the case of international investments, both home and host countries may tax income of foreign firms. This possibility of overlapping jurisdiction can result in double taxation, a very unfavorable situation for FDI. The preferred way of dealing with this problem is the negotiation of double taxation treaties (DTT's), and they either allow for exemption of income generated in a host country or a credit for the taxes paid. These agreements, however, may offer a windfall gain to the investor and may not ensure net additional investments. That is,

DTT's may encourage the repatriation of profits instead of promoting reinvestments in the host country[11].

The full tax treatment of FDI will ultimately depend on the way that home countries tax income earned in host countries. There are two basic principles adopted: the worldwide or residence principle, where all income is taxed in the home country, even when it was already taxed in the host country, and the territorial principle, whereby all income generated in the country's territory is equally taxed, regardless of the residency of the owners. When the territoriality principle is adopted in the home country of the foreign investors (such as France), no tax is imposed on the foreign earnings of residents, and tax incentives granted by host countries can be highly effective. On the other hand, when home countries adopt a residence-based principle of income taxation (such as the US, UK and Japan), tax incentives can many times be of little use. In this case, countries limit themselves to applying a withholding tax on repatriation of profits, levied at rates that do not exceed home country rates, since this will ensure a full compensation from the home country tax credit. However, most capital exporting countries that adopt the worldwide system (not the US) have entered tax-sparing agreements with developing countries. This means that the home country allows the tax credit at the home country tax rates for foreign taxes that have not been effectively paid. In this case, the lower the effective tax rate of the host country, the greater the incentive to attract FDI.

V. FREE ZONES AND JOB CREATION

Most tax incentives in Latin America and the Caribbean (LAC) focus on sector development such as mining, tourism, financial investments or exporting, and are considered as "industrial policy" instruments rather than part of a growth oriented development policy, that would be probably be better served by a broad-based low tax regime. In LAC the incentives are most frequently applicable to free zones. This is actually a worldwide phenomenon that usually follows a clear path of increased value-added as the countries mature and evolve. The generally begin with labor–intensive manufacturing, such as textiles, garments, shoes and toys; later move to consumer durable goods, such as appliances and auto-parts and even into electronics. This development will depend on the availability of local skills that can only result if the countries invest heavily in education and knowledge.

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[11] *Another benefit of DTT is legal protection and stability.*

By and large the fastest growing and most extensively used tax instrument to promote investments are the broadly denominated export processing zones. According to the ILO[12], there are many types of export processing zones (EPZs) which include free trade zones, special economic zones, bonded warehouses, free ports, customs zones and "maquiladoras". The ILO has defined EPZs as "industrial zones with special incentives set up to attract foreign investors, in which imported materials undergo some degree of processing before being re-exported". With developments in information technology, "imported material" would also include "electronic data" today, as well as, call centers located in zones.

EPZs have evolved from initial assembly and simple processing activities to include high tech and science parks, finance zones, logistics centers and even tourist resorts. Their physical form now includes not only enclave-type zones but also single-industry zones (such as the jewelry zone in Thailand or the leather zone in Turkey); single-commodity zones (like tea in Zimbabwe); and single-factory (such as the Export Oriented Units in India) or single-company zones (such as in the Dominican Republic). Madagascar, Mauritius and Hainan (China) allow factories anywhere on the respective island to apply for zone status. Port cities like Hong Kong and Singapore have enhanced their strategic trading role by providing special customs regimes for export processing and transhipment.

While many public agencies are still establishing zones, there is a distinct trend towards the private development of zones, often by foreign developers. Public zones usually offer better infrastructure than that available in the domestic economy, and private zones generally surpass that in an attempt to attract higher quality investment.

According to the ILO, both the number of EPZs and the number of countries hosting them have expanded rapidly. While textiles and clothing and electronics were the main industries initially established in EPZs, the product mix today can include almost any sector.

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[12] *http://www.ilo.org/public/english/dialogue/sector/themes/epz/epzs.htm*

Evolution of EPZs in the World

Years	1975	1986	1997	2002	2006
Number of countries with EPZs	25	47	93	116	130
Number of EPZs or similar zones	79	176	845	3000	3500
Employment (million)	n.a.	n.a.	22.5	43	66
-of which China	n.a.	n.a.	18	30	40
-of which counties with data	0.8	1.9	4.5	13	26

Export Processing Zones in the World (2006)

Geographical area	Employment (1000)	Number of Zones
Asia	55,741	900+
Of which China	40,000	
Central America & Mexico	5,252	155
Caribbean	547	250
South America	460	43
Africa & Middle East	2,547	205
USA & Europe	705	763
Transition economies	1,400	400
Other regions	328	15
Total estimated	65,981	3,500+

The EPZs are among the special economic zones that countries have created since ancient times to spatially limit a region of the country that will be entitled to a special tax or customs regime. The table below, prepared by the ILO, shows the typical evolution (from left to right) that these special zones have presented throughout history.

TYPES OF ZONES: AN EVOLUTIONARY TYPOLOGY

	Trade	Manufacturing			Services		
	Free port	Special economic zone	Industrial free zone / EPZ	Enterprise zone	Information processing zone	Financial services zone	Commercial free zone
Physical characteristics	entire city or jurisdiction	entire province region or municipality	enclave or industrial park	part of city or entire city	part of city or "zone within zone"	entire city or "zone within zone"	Warehouse area, often adjacent to port or airport
Economic objectives	development of trading centre and diversified economic base	deregulation; private sector investment in restricted area	development of export industry	development of SMEs in depressed areas	development of information processing centre	development of off-shore banking, insurance, securities hub	facilitation of trade and imports
Duty free goods allowed	all goods for use in trade, industry, consumption	selective basis	capital equipment and production inputs	no	capital equipment	varies	all goods for storage and re-export of import
Typical activities	trade, service, industry, banking, etc.	all types of industry and services	light industry and manufacturing	all	data processing, software development, computer graphics	financial services	warehousing, packaging, distribution, trans-shipment
Incentives **- taxation** **- customs' duties** **- labour laws** **- other**	simple business start-up; minimal tax and regulatory restraints. Waivers with regard to termination of employment and overtime. Free repatriation of capital, profits and dividends preferential interest rates.	reduced business taxes; liberalised labour codes; reduced foreign exchange controls. no specific advantages; trade unions are discouraged within the SEZ	profits tax abatement and regulatory relief; exemption from foreign exchange controls. free repatriation of profits. Trade union freedom restricted despite the fact that EPZs are required to respect national employment regulations.15 years exemptions on all taxes(maximum)	zoning relief; simplified business registration; local tax abatement; reduction of licensing requirements. Trade unions are prohibited. Government mandated liberal on hiring and firing of workers	demonopolization and deregulation of telecoms; access to market- priced INTELSAT services. a specific authority manages labour relations. Trade union freedom restricted	tax relief; strict confidentiality; deregulation of currency exchange and capital movements.free repatriation of profits	Exemption from import quotas. reinvested profits wholly tax-free

Domestic sales	unrestricted within freeport outside freeport, upon payment of full duty	highly restricted	limited to small portion of production			limited to small portion of production	unlimited, upon payment of full duty
Other features	additional incentives and streamlined procedures	developed by socialist countries	may be extended to single-factory sites				
Typical examples	Hong-Kong (China), Singapore, Bahamas freeport, Batam, Labuan, Macao	China (southern provinces, including Hainan and Shenzhen)	Ireland, Taiwan (China), Malaysia,Dominican Republic, Mauritius,Kenya, Hungary	Indonesia, Senegal	India-Bangalore, Caribbean	Bahrein, Dubai, Caribbean, Turkey, Cayman	Jebel ali, Colon, Miami (USA FTZ) Mauritius, Iran

Source: http://www.ilo.org/public/english/dialogue/sector/themes/epz/typology.htm

VI. LACK OF SUCCESS OF INVESTMENT TAX INCENTIVES

In spite of its growing use, tax incentives alone have not been especially successful in attracting investments, especially FDI. Countries such as Singapore, Taiwan Province of China and Ireland have used investment tax incentives and did succeed in advancing economically. But there are many more countries that failed to induce increased investments with the use of tax incentives and others, like Chile and Estonia that advanced economically without relying on this instrument. Therefore, the causality of the success cases is very much questioned, especially if one considers that the three of them have, for instance, implemented very successful education policies at the same time, as well as provided a stable macroeconomic and political environment. Overall, one can conclude that tax incentives are unable to overcome the more fundamental problems that inhibit investments, although they may be of help when these obstacles are overcome.

But tax incentives have imposed a serious cost on developing countries that need to be considered relative to the modest benefits that they may have promoted. By they nature they represent foregone revenue for the government, and for that reason are considered as tax expenditures. This revenue cost, in many cases, is wasted because the benefit goes to projects that would occur even if there were no tax incentives, resulting in a pure windfall to the investors. Moreover, as a result of the design of the investment tax incentives or difficulties of the Tax Administration in auditing taxpayers at large, great possibilities of unforeseen tax avoidance schemes may be unintentionally created.

Tax incentives introduce complexity into the tax system. First of all because the additional rules that have to be establish to regulate and try to focus them are inherently complex. Also, because as taxpayers try to find loopholes to unduly benefit from them the tax authorities introduce more antiavoidance measures. All of this results in increased transaction costs for both the taxpayers at large and the tax administration. One of these transaction costs is uncertainty of the rules of the game. And uncertainty may scare away prospective investors.

Aware of the complexities of establishing a tax incentives programs, it is often justified as a needed temporary arrangement. Worldwide experience shows that they are seldom “temporary” and only designed

to respond to particular disincentives. They usually remain in force for long periods, even after the original conditions that led to their creation no longer prevails. And frequently enough, rules that were intender to attract new investors end up being extended to existing firms on the grounds of isonomy.

VII. INCENTIVE ADMINISTRATION AND CREDIBILITY OF THE TAX REGIME

The four stages concerning the establishment of a tax incentives system are: a) design, b) concession, c) implementation, and d) compliance control. The success of a tax incentive regime will depend on each and every stage. Although incentives are part of the tax legislation, they are often managed by agencies other than the tax administration, and this can lead to business inconveniences and ultimately seriously affect the final results. In federal systems of government, the national and state governments may offer different tax incentive packages and not coordinate between themselves. Competition between different subnational governments could be good for firms but detrimental to the overall interests of the country.

Frequent changes in the tax regime or excessive flexibility in the design or application of the incentive package (including other non-tax benefits) can complicate the analyses of the tax incentives. A policy that is seen as temporary may have little effect to attract investments. Furthermore, the perspective that a competitor might receive an even better treatment further down the road can also water down what was originally intended. If the tax regime is not credible, investors seek rates of return significantly higher than in a lower risk environment and the subsidies provided through the tax incentives may prove to be insufficient. Stability and predictability are highly appreciated particularly in long-run investments such as oil and mineral industries.

It is not advisable to provide tax incentives as a form of ad hoc tax reform in order to remedy systematic deficiencies of the tax system. If the business climate in a country is a problem, this may indicate that a comprehensive tax reform may be needed rather than makeshift adjustments. Tax incentives usually only provide assistance to new companies, and the sound functioning of existing firms may prove essential to the economy and the overall business climate.

VIII. TAX EXPENDITURES

The concept of Tax Expenditures was used for the first time in 1967 by Stanley Surrey[13] [1973] that at that time was the Assistant Secretary for Tax Policy in the Treasury Department of the USA. Surrey realized that the provisions in the income tax legislation containing special exemptions, exclusions, deductions and other tax benefits were really methods of providing governmental financial assistance. These especial provisions were not part of the structure required for the income tax itself, but were instead Government expenditures made through the tax system. Since they were similar in purpose to direct government expenditures, but provided through the tax system, he called them “tax expenditures”.

The novelty of Surrey’s approach was to see that the ‘old” tax incentives were actually disguised forms of government expenditures, and for that matter they had a cost. The foregone revenue resulting from the “special” tax regime..

Tax expenditures are broadly defined as provisions of tax law, regulation or practice that reduce or postpone revenue for a comparatively narrow population of taxpayers. Fiscal incentives at large are part of the tax expenditures, although many tax benefits there also included, such as special treatment of income from senior citizens, can’t be considered an “incentive”.

The important thing is that if policymakers clearly knew the cost of the tax incentives, that is, how much revenue they are not collecting because of the especial legal dispositions that were created to attract investments, they (or other agents of civil society) could more easily compare the costs and benefits of the policies the tax incentives were supposed to promote. Were the jobs created? At what cost? In what region of the country? Have they triggered development? All in all, have they delivered on their promises?

For the sake of transparency and democratic governance, all countries that have in place some tax incentive program (and all of them have) should prepare a tax expenditure budget that consists of an estimate of the foregone revenue that has resulted from the special tax regimes, indicating the beneficiary sectors, areas and even maybe regions.

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[13] *Surrey, Stanley. “Pathways to Tax Reform: The Concept of tax Expenditures” Harvard University Press, Cambridge, USA, 1973.*

IX. GLOBALIZATION, TRADE AGREEMENTS AND INVESTMENT PROMOTION

Globalization is the result of the growing integration of economies and societies around the world. Integration has resulted from reduced transport costs, lower trade barriers, rising capital flows and faster communication of knowledge and ideas. Although it has generated economic opportunities, the integration process does not come without risks and problems. The growing interdependency among national economies generates a smaller tolerance for divergence in their domestic policies, which calls for stronger international coordination.

Particularly in tax matters, there is a potential conflict between greater transnational economic activity and the desire of policymakers to retain their sovereign ability to take whatever domestic decision they believe is proper, including the concession of tax incentives to promote foreign investment. With increased economic integration it has become more difficult to separate domestic from international policies. Now and even more in the future, national tax policies affect other countries, and are influenced by other countries' tax policies as well. The increased mobility of factors, especially capital, implies that flows to different countries become very sensitive to tax treatment differentials, and the growth of economic activities taking place outside a country's borders may hinder its capacity to properly levy its taxes as it wishes.

With the growing interdependency of economies and rising cross-border activities, countries are changing their tax instruments and this results in the redistribution of the tax burden and less incidence on mobile factors. Capital is being taxed less and less, and labor and consumption more. This means that taxation is becoming less equitable and promotes more economic distortions as the quality of the tax systems is deteriorating in most countries. In the long run this works against promoting a generally sound business environment needed to foster economic activities.

Furthermore, with globalization the distinctions between trade, investment and tax agreements are becoming increasingly blurred. The importance that was given to the trade in service negotiations of the Uruguay Round and the growing presence of FDI is making clear that taxation of factor incomes can constitute a barrier to free trade as tariffs have traditionally done. The increased competition for FDI and the eagerness to expand exports and gain international market share has led to the growth of tax incentives.

For this reason trade agreements can no longer ignore taxes. Inadequate tax policies and incentives are included within the host of non-tariff barriers that are being abolished in order to enhance free trade. Among them the classical quantitative restrictions, sanitary regulations and anti-dumping rules as well as production and export subsidies. All subsidies that increase exports or decrease imports are scrutinized, including those granted through the tax system. The GATT established a Subsidies Code in 1994 including cases where “government revenue that is otherwise due is foregone or not collected.” The WTO has gone further in the pursuit of eliminating tax distortions to free trade. Income tax reductions or exemptions within free trade zones within low-income countries that were tolerated in the past are to be eliminated by 2015 in accordance with the agreements of the Doha Development Agenda.

Considering that policymakers in democracies would rather do something rather than nothing, and that tax incentives are an attractive short cut to more meaningful structural reforms, the question is; will these trade rules or other measures restrict in a significant way the possibilities that countries have to promote the attraction of investments through the use of tax incentives?

Tax incentives, if granted, have to be: a) strategic, thus linked to a coherent set of policies for development of determined sectors or geographic area; b) designed to phase out in a period of time; c) transparent to avoid discretionary criteria and opportunities for lobbying or corruption; and d) finance authorities should measure the fiscal impact of the incentives and its economic present value..

In summary, tax incentives generally will not make up for serious deficiencies in the investment environment or generate significant externalities. Nevertheless, with a more globalized economy with freer trade and financial flows, whenever political and economic stability, infrastructure, and transport costs are more or less equal between potential locations – ones that have the other necessary attributes – then taxes may exert a significant impact. This in very much evident from the growing tax competition within federal countries (Brazil and the USA) or within regional groupings, such as the European Union.

Case study

Topic 1.2

TAX INCENTIVES ON INVESTMENT AND TAX EXPENDITURE IN LATIN AMERICA

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CONTENTS: 1. Introduction.- 2. Investment, growth and tax policy.- 2.1. The importance of investment in Latin America.- 2.2. Tax policy and investment. – 3. Tax incentives on investment.- 3.1. Types of tax incentives.- 3.2. Types of tax incentives.- 3.3 Free trade areas.- 4. Measuring tax incentives: Tax expenditure.- 4.1. Measuring the tax cost of tax expenditure: certain theoretical issues.- 4.2 Measuring tax expenditure in Latin American countries: different methodologies.- 4.3. Quantification of tax expenditure in Latin America.- 5. Final remarks and future challenges.- 6. Methodological annex

1. INTRODUCTION

Although historically the economies of Latin America have been marked by their low and volatile growth, in the last few years they have experienced an upturn in their performance by an improvement in several indicators, chiefly the activity level and the investment rate. Nevertheless, such recovery is far from the growth of past decades and is significantly lower to the growth of other regions in the world.

In the growth of recent years, investment has been the most dynamic demand factor in the majority of the countries in the region. Nevertheless, it is still behind with regards to the pre-debt crisis level and numerous papers have emphasized that it is still insufficient to ensure sustainable growth. Therefore, it is relevant to analyze the different forms of public policy to promote a higher investment rate.

This paper shall reveal the different forms in which the tax policy influences the level of investment, particularly focusing on the form in which countries record the tax cost of the tax incentives, which is usually known as “tax expenditure”.

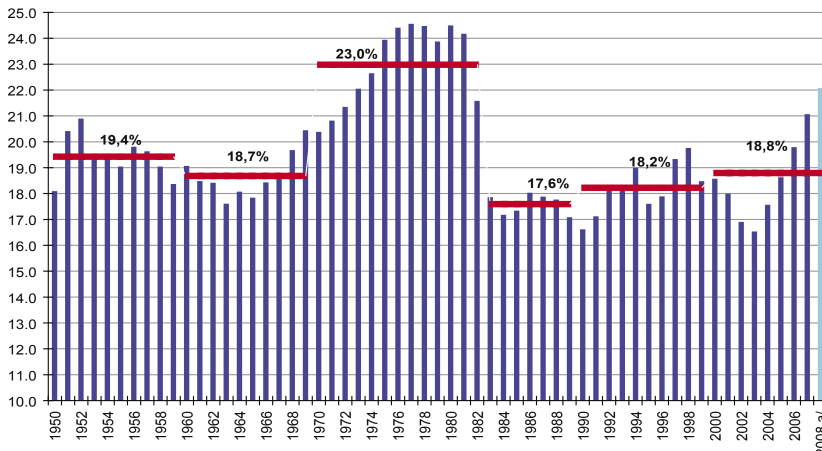
Therefore, the paper is organized as follows: firstly, we shall briefly review the investment evolution in the region in the last few years and its impact on growth. Following, we shall analyze the different types of tax incentives employed in the region and review the available literature to assess its effects. Section four shall analyze in detail the form by which countries measure tax incentives via the so-called tax expenditure. Additionally, we attach an annex including the detailed methodologies employed by numerous countries of the region to record such tax expenditure.

2. INVESTMENT, GROWTH AND TAX POLICY

2.1. The Importance of Investment in Latin America

As mentioned in the introduction, although the countries of the region have experienced an upturn in growth and investment in the last few years, this recovery is far from the levels recorded prior to the debt crisis and is significantly lower with respect to other regions such as Asia, Eastern Europe and the Middle East.

Figure 1: Fixed Investment Rate
(In percentage of GDP)



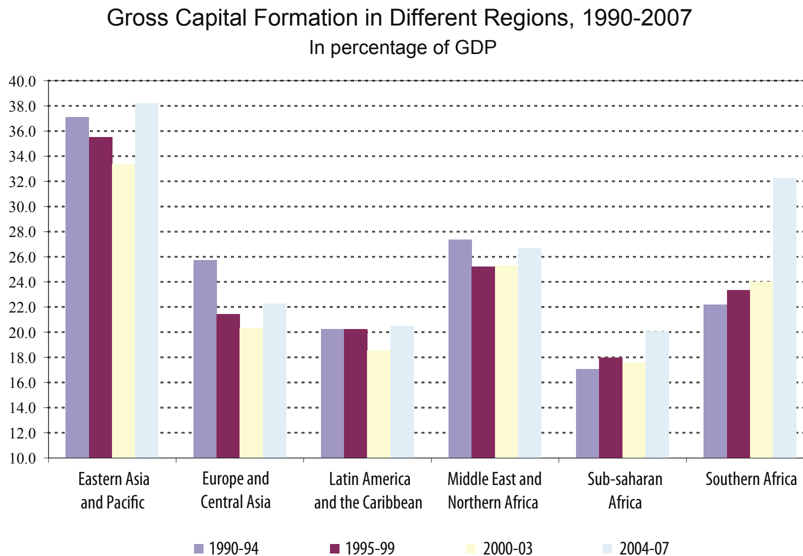
SOURCE: ECLAC (2008)

As we may observe in **Figure 1**, based on foreign debt incurred in the seventies, the investment rate showed a sustained upward trend that was suddenly disrupted by the debt crisis. As of 1982, the investment ratio drops significantly, from levels close to 25% of the GDP to less than 18%. In the 1991-2003 period, the investment rate slightly increased until 1997, then dropping to lower levels with respect to the beginning of

the decade. This situation changes again as of 2004, when investment becomes the most dynamic factor of the demand, fostered chiefly by investment in durable equipment (Kacef and Machinea, 2007).

The investment level in the region is not only low with respect to its own history, but also when compared with other regions of the world. On comparing data on investment, saving and growth, as of 1990 we observe that Latin American countries are among the regions with lowest investment and saving rates. Investment rates in Latin America are the lowest of all the regions just as set forth in the following Figure (ECLAC 2007).

Figure 2

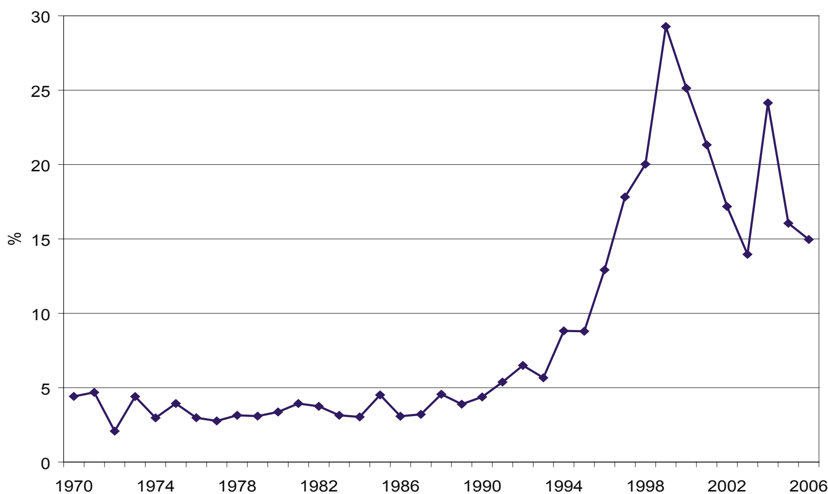


Source: ECLAC document based on the World Bank World Development Indicators (WDI) database.

Part of the recovery of the investment rates of the last few years may be attributed to the growth in Foreign Direct Investment (FDI) in the region. The FDI in Latin America and the Caribbean acquired greater relevance since the nineties, a time marked by a wave of privatization of government-owned companies and, as explained hereunder, popularity of free trade areas. In the last three years the income from FDI has accounted for approximately 15% of gross fixed capital formation in the region; nevertheless this share is quite lower than 29% recorded in 1999 and 24% in 2004 (Figure 3). According to ECLAC (2008), the FDI in Latin America and the Caribbean grew in

excess of the average for developing countries in 2007 and reached 3.6% of the regional GDP.

Figure 3: Latin America and the Caribbean: Share of the income of Foreign Direct Investment in the gross fixed capital formation, 1970–2006
(In percentages**)**



Source: UNCTAD, World Investment Report 2007

2.2. Tax Policy and Investment

Conceptually, several points of contact are normally highlighted between the tax policy and investment.

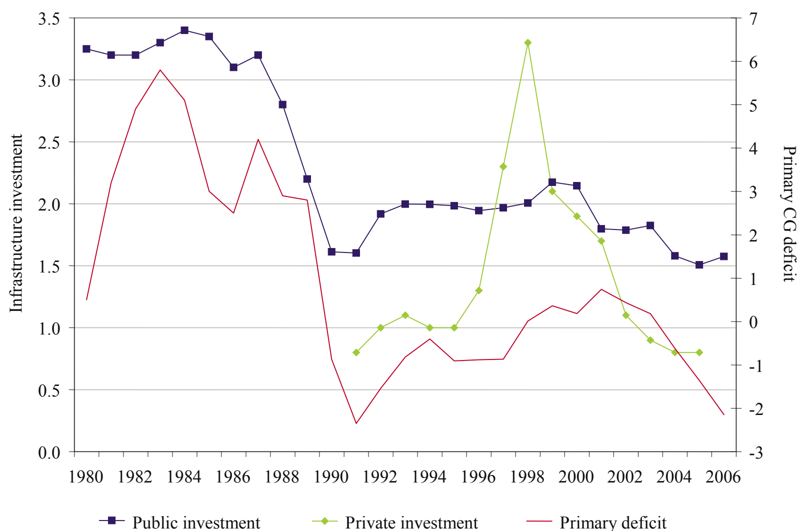
The first element emphasized in literature normally highlights the relation between fiscal deficit financing and private investment, through variables such as financing, exchange rate and interest rates (Chhibber and Dailami, 1990). In this respect, the relation would be fundamentally based on the crowding out effect, which occurs as a consequence of the budgetary deficits that lead to an increase in government indebtedness, which would foster an interest rate hike, shifting private investment. Nevertheless, this effect shall depend on the reaction of financial markets to the greater government indebtedness.

The second aspect considered in the relation between tax policy and investment refers to the supplemental nature or competition between public and private investment. In the first case, public investment in public services and infrastructure bears a positive impact on the profitability of private investment since it reduces private production

costs and may increase the demand and the use of the installed capacity. The supplemental relation between public investment and private investment is chiefly present in public investment in infrastructure and in education. On the other hand, public investment may compete with private investment in obtaining funding and productive supplies. In developing countries the competition in the financial market may be more relevant owing to the fact that the credit supply is more restricted, displacing private investment to a given extent.

The following Figure shows the relation between the fiscal deficit and the private and public investment in infrastructure in Latin America, where we may observe that after the debt crisis that broke out in 1982 the tax deficit reduction was largely achieved at the expense of a lower public investment in infrastructure. Although the production of primary surplus in the first half of the 90s enabled a certain public investment recovery, it remained low, given the general idea that the private sector should replace the public sector in infrastructure investment, which was made evident in the implementation of new forms of funding such as concessions. Nevertheless, private investment did not suffice to overcome the shortages of public investment. After the economic crises at the end of the nineties, public as well as private investment experienced a downward trend in the 1999-2005 term.

Figure 4: Latin America: Public and private infrastructure investment and Central Government Primary Deficit
(In percentage of GDP)



Note: the private investment data account for amounts allocated to infrastructure.
Source: ECLAC based on official figures.

The third aspect with regards to the relation between tax policy and investment, which shall be specifically addressed in our analysis, refers to the role of the public sector and the use of the tax and subsidies' system as a tool to influence investment via tax incentives. Tax incentives tend to reduce the cost of capital and, therefore, seek to increase private investment, mitigating the liquidity restrictions faced by corporations and increasing their cash flows[1].

Literature addressing the factors that determine saving and investment find different points of contact between the tax policy and these variables. According to ECLAC (2007)[2], we may appreciate a positive relation between national revenue and savings, that is to say, a low deficit or a fiscal surplus contribute to savings. Thus, an increase in government savings is not fully set off by a reduction in private saving, by which the tax policy constitutes an instrument to improve savings and investment.

This literature also emphasized certain indirect relations between tax policy and investment. In such regard, an important determining factor for investment is given by the future growth expectations. Should expectations be positive, a higher capital return is expected and, therefore, greater investments generated. Additionally, owing to the irreversible nature of capital, since once installed it is very costly to shift it to a different activity, the investment is very sensitive to conditions of uncertainty and risk. Thus, the possibility and capacity of the investor to take control of the return on investment is very important. In this sense, the intellectual property rights' policies, the appropriate performance of the Judiciary, clear legislation and rules and stability of tax and macroeconomic policies are particularly relevant.

3. TAX INCENTIVES ON INVESTMENT

As highlighted in Gómez Sabaini (2006) tax incentives on investment marked the development of numerous countries in the 50s and early 60s. It emphasizes that they are part of the set of economic policy instruments employed by developed as well as developing countries and one of the tax aspects focusing attention beyond the world economic scenario change and the successive tax reforms.

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[1] *Next section analyzes the effects of tax incentives in greater depth.*

[2] *In ECLAC (2007), the determining factors for savings in 9 countries of Latin America are analyzed for the 1990-2003 period.*

Such incentives, although originally aimed at fostering investment and FDI and related to the imports' substitution process, diversified their objectives in time to the extent they broadened the exemptions to other taxes.

Along such lines, Keen and Simone (2004) point out that developing countries not only feature a greater variety of tax incentives with respect to developed countries but said incentives are currently more common in developing countries than a decade ago[3].

3.1. Types of Tax Incentives

In general terms, we may state that tax incentives seek to affect the behavior of economic actors at a limited fiscal cost. Among the normal objectives pursued, in addition to the investment increase, we may mention the development of regions that are lagging behind, promotion of exports, industrialization, employment generation, technology transfer, diversification of the economic structure, and training and development of human capital. It is important that the objectives be explicit so as to enable to measure effectiveness in terms of costs for the rest of society.

These tax incentives may take different forms:

a. Tax holidays and tax rates' reduction.
b. Investment incentives (accelerated depreciation, partial deduction, tax credits, and tax deferrals).
c. Incentives to employment (employment subsidies, reductions in payroll taxes).
d. Special areas with preferential tax treatment (import duties, Income Tax, Value Added Tax).

Tax holidays constitute one of the most common forms of tax incentives, exempting corporations from the payment of Income Tax for a given period. Nevertheless, since generally speaking, new businesses are not profitable in the first years, if they are unable to carry over the losses incurred during the exemption term to future fiscal years, this incentive may be of little use. Another widely disseminated investment incentive modality in countries is lower Corporate Income Tax rates. Nevertheless, such measures may not be efficient to attract FDI from

[3] *Mentioned in Bird (2006).*

countries adopting the principle of worldwide income.[4] As observed in Table 1, while most of the benefits granted by developing countries are based on tax exemptions, OECD countries chiefly resort to subsidized loans.

Table 1: FDI INCENTIVES IN DEVELOPING COUNTRIES AND OECD MEMBER COUNTRIES.

FDI Incentives	% OECD Countries	% Dping. Countries
Import duties for exempted capital assets	5	56
Tax Exemptions	20	55
Permit to invest/reinvest earnings	30	49
Lower tax rates	5	45
VAT exemptions for capital assets	0	34
Accelerated amortization	30	30
Import duties for exempted raw materials	5	30
VAT exemption for raw materials	5	24
Import duties refunds	5	24
Preferential treatment for income from exports	0	20
Carryover of Income Tax losses	0	18
Reduction in taxes and local and municipal service charges	30	18
VAT exemption for exported supplies	10	18
Subsidized loans	45	18

Source: World Bank (2003), de Bora (2002).

Mentioned in Gomez Sabaini (2006)

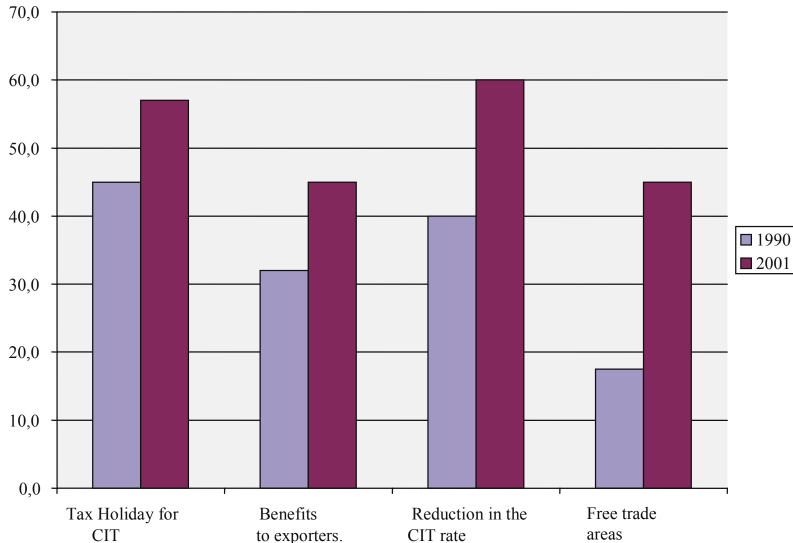
Different reasons may explain the reason why the countries in the region have preferably used tax exemptions. Probably the infrequent use of direct subsidies is tied to the small capital markets and a lower development of financial tools.

In this respect Keen and Simone illustrate the advance of tax incentives and the change in the structure thereof in developing countries on the basis of a sample of forty countries comparing the regulations in place at the beginning of the 90s with respect to the year 2001. Particularly,

[4] *Villela and Barreix (2002) set forth that a more effective way of reducing the Corporate Tax burden is to artificially deduct their net income, whether by allowing them to carry over losses from previous fiscal years for a significant number of years or by an accelerated amortization system. Although certain countries apply direct investment permits, granted in the form of deductions of the tax base, the final effect depends on the applicable tax rate. Therefore, they are frequently granted together with tax rate reductions or as investment tax credits, instead of deductions or investment permits. Another form of incentive to attract FDI is the use lower rates for the tax applicable on dividend or interest remittances to foreign jurisdictions. The latter reduced the financial costs but the former could foster an eventual repatriation instead of reinvestment of capital.*

this sample shows the growing importance of free trade areas in the total incentives granted, which equal the benefits to exporters, but lag behind the different Income Tax exemptions (refer to Figure 4).

Figure 5: Evolution of tax incentives in developing countries.
(Percentage of developing countries in the sample.)



Source: Keen and Simone (2004).

As Richard Bird (2006) asserts, although tax experts generally continue recommending the design of tax systems with low tax rates and broad tax bases, the discussion as to the use of tax incentives has reappeared in the last few years. Along such lines, ECLAC (2008) mentions certain recently implemented tax policies aimed at attracting foreign investment to the region. For example, Brazil has adopted a special tax system for the acquisition of machines and equipment used in infrastructure works. On the other hand, Colombia, has applied a progressive Income Tax reduction, created special free trade areas and advanced in the negotiation of double taxation agreements. Costa Rica analyzes the possibility of changes in the tax incentives' structure for FDI, while El Salvador passed a law providing for the total exemption of import duties on the capital assets required to conduct business activities, exemption of Income Tax and municipal tax on goods and capital of corporations as well as the VAT exemption on the purchase of supplies and services required to operate.[5]

[5] *For further details, refer to ECLAC (2008), "Foreign investment in Latin America and the Caribbean - 2007".*

3.2. Types of tax incentives

The effectiveness of such instruments is anything but controversial. In general terms, the literature reviewing the effects of tax incentives on FDI, shows only a secondary influence on the level and location of investments.

According to Gomez Sabaini (2006), such incentives are only effective when a country already features certain minimum conditions pursued by corporations, such as economic stability, skilled labor, proximity with destination markets, legal certainty, etc.

In line with this assertion, Bolnick (2004) points out that countries normally deemed successful with respect to their tax incentives policies are those that established such incentives in a context of stable political and economic conditions, with an educated labor force, a good level of infrastructure, commercial openness for exporters, reliable rule of law and effective investment promotion systems.[6]

In such respect, authors such as Blomström[7] point out that evidence shows that many of the incentives offered by developing countries only play a limited role in multinationals' investment decision, since other overriding prerequisites exist in such decisions, and thus, the incentives offered by governments for foreign investment possibly play a decisive role only in the cases in which businesses are excluded.[8]

Along the same line of thought, Thirsk (1991) indicates that investment incentives are more likely to be effective in countries with less inflation rate, exchange rate and growth rate fluctuations.[9]

Among the studies of developing countries concluding that tax incentives have been ineffective in fostering investment, we may mention: Estache and Gaspar (1995) for Brazil, Wells et al (2001) for Indonesia, Boadway et al (1995) for Malaysia and Bernstein and Shah (1995) for Mexico, Pakistan and Turkey.

Our studies for USA determine that taxes generally feature a small effect on the behavior of corporations and thus, in the economic development, employment and investment. According to such studies, inter-regional elasticity of the economic activity with regards to taxes ranges at approximately -0.1, which entails that a 10% tax reduction

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[6] *Quoted in Bird (2006).*
[7] *Blomström et al. (2000).*
[8] *Gómez Sabaini, (2006).*
[9] *Quoted in Bird (2006).*

would only increase employment, investment or the establishment of new businesses by 1%. Nevertheless, the elasticity for intra-regional studies is more significant (around -0.4), which would indicate that in the cases in which the decision to locate a business is restricted to a smaller area, the non-tax factors are similar and, therefore, taxes would play a more relevant role in this decision.[10]

Overall, we may state that tax incentives constitute only one of the factors that may affect the FDI flow, since other more relevant elements exist to attract foreign investors, external to the tax system. Recently, several authors (Bird, 2006; Villela and Barreix, 2002)[11] have pointed out that although in an international context taxes are also secondary elements in attracting investment, with economic integration tax incentives are turning into an increasingly relevant decision factor in locating the FDI, since regional markets become more homogeneous and taxes could have a greater weight in the decision to locate businesses.

Of course, beyond the effectiveness or ineffectiveness of tax incentives in increasing investment, other effects should be highlighted. For example, they reduce the tax burden of the beneficiary sectors generating less revenue for the Administration and impairing equity; they make the tax systems more complex, increasing compliance costs and tax evasion; they deprive the tax policy of transparency and also distort resource allocation.

3.3. Free Trade Areas

In the last two decades, tax exemptions in preferential tax jurisdictions, commonly called “free trade areas” have become especially disseminated. As Gómez Sabaini (2006) points out, although the foreign investment attraction schemes and especially *maquila* industry promotion in the region date back to the seventies, the nineties were definitely the golden age for free trade areas in Central American countries.

Free trade areas consist in specific areas in a country that apply certain tax benefits, such as the exemption of import duties, taxes and other levies enforced by customs. That is to say, within this area, goods are not subject to the normal control of the Customs service and their introduction or removal is not levied.

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[10] *Wasylenko (1997) quoted by Villela and Barreix (2002).*

[11] *Villela and Barreix (2002), “Taxation and Investment Promotion”, Inter-American Development Bank.*

By establishing free trade areas, governments normally seek to promote and diversify exports, acquire foreign currency, attract foreign investment, generate employment and the economic development of distant regions or regions with less relative development.

In the early eighties, while the imports' substitution model was discontinued, the countries of the region relied on the opening up of their economies and attracting investment to generate employment and economic growth. One of the instruments employed for this strategy was the adoption of free trade areas systems that promoted the diversification of exports and served as a source of foreign income.

Rodríguez and Robles (2003), in their summary of the main incentives for the free trade areas in Central America, point out that the exemption periods may vary but are extensive in all the countries and practically all businesses enjoy the same exemptions: 100% for taxes on the import of raw materials (including fuel), machinery and equipment, 100% for repatriation of income and 100% for sales and assets' taxes. In the case of Income Tax, the exemption is also 100% but for variable terms that range from 8 years in Costa Rica (and then extend the 50% exemption for 4 additional years) or do not feature a limitation, such as the case of Honduras. Something similar occurs with municipal taxes and service charges that are 100% exempted for 10 years -in Costa Rica- or without limitation -in Guatemala, Honduras and Nicaragua-. No restrictions apply on the handling of foreign currency or requisitions for local purchases.

In the case of South American countries, the tax incentives in place in the free trade areas are similar. For example, legislation in Chile provides for exemption of VAT and first category Income Tax (not the supplementary and additional global tax) without time restrictions. Bolivia enforces exemptions on real estate property, VAT (and its supplemental tax), tax on transactions, specific consumptions, tax on the presumptive income of corporations and municipal taxes.

Following, we present the number of free trade areas in different countries of Latin America and the Caribbean. It highlights the more intensive use of such areas in Caribbean and Central American countries, since they are economies closer to large markets (United States and Canada) and smaller domestic markets.

Table 2. Latin America and the Caribbean: number of free trade areas in selected countries. Year 2008

Country	Number	Country	Number
Argentina	11	Honduras	9
Belize	1	Mexico	1
Bolivia	12	Nicaragua	24
Brazil	1	Panama	1
Chile	2	Paraguay	2
Colombia	9	Peru	4
Costa Rica	19	Puerto Rico	1
Ecuador	7	Dominican Rep.	49
El Salvador	4	Uruguay	9
Guatemala	5	Venezuela	1

Source: Guide of Free Trade Areas of Latin America and the Caribbean, IDB-INTAL.

Different papers emphasize the significant impact of the free trade areas in Latin America and the Caribbean on the economic activity in terms of trade, employment and foreign investment. According to Gomez Sabaini (2006,) the growth of businesses in free trade areas has been exponential in Central America during the last ten years, since the few tens of businesses that existed in 1990, grew to 1,100 in 2001 under these special regimes. They hired more than 354,000 individuals, which accounts for over 26% of the overall employment in the Central American manufacturing sector. In 1990, the businesses in free trade areas barely employed 20,000 direct employees. Likewise, exports have grown significantly: while in 1990 exports from free trade areas amounted to 231 Million Dollars, or 20% of the total exports' amounts from Central America, in 2001 they grew to almost 5.2 Billion Dollars, or 40% of total exports. On the other hand, the total number of businesses from free trade areas contributes with more than 2.4 Billion Dollars in value added in Central America, 4% of the total production in the region, when at the beginning of the nineties the contribution to GDP was almost zero.

Pursuant to Granados (2003), in certain countries like Dominican Republic, Costa Rica, Honduras, El Salvador and Bolivia, free trade areas have been essential in promoting and diversifying exports, generating employment and attracting foreign investment. For such countries, exports from free trade areas accounted for 43% and 81% of total exports in the year 2000.

Table 3: Latin America and the Caribbean: Exports from free trade areas in selected countries. Year 2000.

Country	Exports F. Trade Area (Million US$)	% Total exports
Dominican Rep.	4,770	81.1
Costa Rica	2,986	51.1
Honduras	2,362	50.0
El Salvador	1,452	48.8
Bolivia	537	43.7
Peru	2,757	40.0
Nicaragua	272	21.8
Chile	1,449	8.0
Guatemala	195	6.5
Colombia	601	4.3
Brazil	772	1.4

Source: Granados (2003) based on the Free Trade Areas' Committee of the Americas

In general terms, we may assert that attracting FDI has been mainly based on Income Tax exemptions and the duty-free imports. Nevertheless, it is worth considering that the Income Tax exemption has become unfeasible according to the new rules of the World Trade Organization (WTO), expressly banning such exemptions beginning in 2010. Additionally, the multilateral and regional trade obligations assumed by many countries in the region eliminate or reduce the main incentives granted by the free trade areas, such as those referred to duty-free imports exports and other customs exemptions.

4. MEASURING TAX INCENTIVES: TAX EXPENDITURE

The foregoing tax incentives are difficult to quantify in tax terms. As a form of quantifying the tax cost of the incentive, governments have advanced in measuring the loss of revenue upon the implementation of this measure. This form of quantification is called tax expenditure.

The term tax expenditure has been attributed to Stanley Surrey, who as the Assistant Treasury Secretary in 1967, compiled a list of preferences and concessions for the Income Tax, making it equivalent to an expenditure program (see Burman 2003)[12]. The idea behind this

[12] *Surrey stated that he adopted the term tax expenditure owing to the similarity of these tax preferences with direct expenditure programs, also emphasizing that they should be subject to budgetary control processes.*

principle is that the revenue lost with the exemption could be collected and spent on that option or another one. Therefore, in order to assess the opportunity cost of the exemption, we must calculate the revenue loss. Of course, in order for this exercise to be complete, we should compare the cost of this waiver with its impact and the impact of alternative measures.

In recent years, the term tax expenditure has been used as a synonym for incentives vis-à-vis tax exemptions and has been extended to a larger number of taxes.

Thus, in agreement with the OECD (2003), tax expenditure may be defined as a transfer of public resources applied via tax reductions with respect to a benchmark instead of employing a direct subsidy.

According to Craig and Allan (2002), tax expenditure may be considered in general terms as a non-transparent form of preferential tax regimes, where the government objectives for a specific sector are pursued by differential tax incentives or disincentives instead of expenditure.

Therefore, in a broad sense, the notion of tax expenditure may be understood as the revenue that the Administration ceases to collect as a consequence of the application of exemptions or special tax systems, whose purpose is to favor or promote certain sectors, activities, regions or economic agents.[13]

4.1. Measuring the Tax Cost of Tax Expenditure: Certain Theoretical Issues

Quantifying the tax cost of this type of incentives via the entity of the tax expenditure has been no simple task. According to Burman (2003), the key difficulty in measuring it arises from the definition of a normal tax structure or benchmark, that is to say, establishing the component of the tax structure.

The most habitual benchmark is deemed the structure established by tax law in order to consider tax expenditure as the entity departing the general description in tax law. Another possibility is to consider a very broad tax base as the benchmark, by which any exclusion of such base would originate tax expenditure. An example of this conceptual approach would be the notion of Haig Simons for Income Tax or a broad consumption-type base for VAT.

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[13] *Barra and Jorrat (2002).*

Another relevant aspect is the tax expenditure calculation methodology, according to the following approaches: ex post, ex ante and equivalent expenditure. The first one, based on a partial balance exercise, estimates the revenue loss by the Administration assuming that taxpayers would not change their behavior with the annulment of the tax incentive. The ex ante method estimates the revenue for the Administration upon eliminating the preferential treatment, by which it considers an assumption of a change in the behavior of beneficiaries. Lastly, the equivalent expenditure approach measures the cost of providing the same monetary benefit granted by the tax expenditure via a direct expenditure.

The OECD (2004) makes certain recommendations to quantify tax expenditure to determine the tax benchmark as well as the calculation method. As regards the first element, it indicates that the benchmark shall not necessarily be based on the legal structure of the tax and shall be broad and unique. As a benchmark example it mentions a broad income of the type defined by Haig Simon, broad consumption, value added and sales in certain types of products. Additionally, it sets forth that all tax expenditure shall be calculated and recommends calculating the revenue loss.

4.2. Measuring Tax Expenditure in Latin American Countries: Different Methodologies

In the last few years, several countries in the region have started to perform an official estimation of the so-called tax expenditure and in most cases; they are included in the annual message attached to the budget.

In general, countries of the region tend to employ the ex-post method of tax waiver with certain adjustments. The differences are fewer as regards the frequency of reports and scope, since they are mostly annual and involve the central government.

With regards to the type of taxes analyzed, countries are basically focused on the Value Added Tax (VAT) and Income Tax (Individual and Corporations) since they constitute the taxes that generate more revenue. Nevertheless, Brazil does not include the tax expenditure calculations for the tax on the circulation of goods and services (ICMS, as per the Portuguese acronym), a state tax. On the other hand, Argentina, Brazil, Guatemala, Mexico and Peru include in their analysis the tax expenditure applied on certain specific taxes,

and only Argentina includes the one applicable on Social Security contributions.

In addition to offering information on the type of tax affected, most of the countries tend to specify the tax waiver modality (exemptions, deductions, special rates, etc.) as well as the sector benefiting and/or the objective pursued. In the case of Brazil, the regions benefiting from this type of incentives are detailed.

Following is a comparative table summarizing the features of the methodologies employed by some of the selected countries, which are presented in detail in a methodological attachment.

Table 3: Latin America. Key features of tax expenditure

	Argentina	Brasil	Chile	Colombia	Ecuador	Guatemala	México	Perú
Fuente	Mensaje del Proyecto de Ley del Presupuesto de la Adm. Nacional	Informe de Gastos Gubernamentales Indirectos de naturaleza tributaria	Informe de las Finanzas Públicas. Proyecto de Ley de Presupuesto	Proyecto de Ley del PGN	Gasto Tributario (SRI)	Informe de Gasto Tributario- Proyecto de Presupuesto	Presupuesto de Gastos Fiscales	Marco Macroeconómico Multianual
Periodicidad	Anual	Anual	Anual	Anual	Anual	Anual	Anual	Anual
Cobertura	Sector Público Nacional	Gobierno Central	Gobierno Central	Gobierno Central	Gobierno Central	Gobierno Central	Gobierno Central	Gobierno Central
Impuestos	- Ganancias - IVA- Combustibles - Comercio exterior - Bs Personales - Internos - Ganancia mínima presunta - Seguridad Social	- Renta - Importaciones - IPI - IOF - Prop. territorial rural - PIS-PASEP - Lucro líquido - Cofins	- Renta - IVA	- Renta - IVA	- Renta - IVA	- Renta - IVA - IPF - IETAAP - Aranceles - Petróleo - Tabaco - Bebidas - Vehículos - Cemento	- Renta - IETU - IVA - Impuestos especiales (IEPS, ISAN e ISTUV)	- Renta (IRPJ, IRPN) - IGV - ISC - Ad valorem - Derecho especial - ISND
Tipos de gastos tributarios	- Exenciones - Deducciones - Alícuotas reducidas - Regimenes de promoción - Pagos con bonos o certif. crédito fiscal	- Exenciones - Deducciones - Alícuotas diferenciadas - Programas de apoyo o promoción - Zonas Francas	- Exenciones - Deducciones - Alícuotas diferenciales - Diferimientos - Amortizacion acelerada - Reg. especiales - Créditos tributarios	- Exenciones - Deducciones - Descuentos - Exclusiones	- Exenciones - Deducciones	- Exenciones - Deducciones - Crédito fiscal - Franquicias - Desgravación arancelaria - TLC - Contingentes arancelarios	- Exenciones - Deducciones - Alícuotas diferenciales - Diferimientos - Subsidios y créditos fiscales - Regímenes especiales	- Exoneraciones - Deducciones - Alícuotas diferenciadas - Devoluciones - Diferimientos - Inafectaciones - Créditos - Zonas francas

Metodología	- Ex-post 1/ - Enfoque: largo plazo - Benchmark: Legislación tributaria	- Ex-post 1/ - Enfoque: largo plazo - Benchmark: Legislación tributaria	- Ex-post + supuesto de cambio de comportamiento - Benchmark: Legislación tributaria en renta y tipo consumo para IVA	- Ex-post 1/ - Benchmark: Legislación tributaria- El GT de IVA se considera a una tasa de 1%	- Ex-post 1/ - Benchmark: Legislación Tributaria	- Ex-post 1/ - Benchmark: Legislación Tributaria	- Ex-post 1/ - Enfoque: corto plazo - Benchmark: Renta mundial para ISR y tipo consumo para IVA	- Ex-post 1/ - Enfoque: corto plazo - Benchmark: Legislación Tributaria
Clasificación	- Por tributo (según procedencia: leyes o reg. prom. y modalidad) - Por régimen de promoción económica (según tributo)	- Por tributo (según modalidad y región) - Por función presupuestaria (según modalidad y región)	- Por tributo según modalidad - Por sector u objetivo beneficiado - Por partidas más relevantes	En Renta: - Por tipo de beneficio - Por modalidad y tipo de declarante - Por subsector económico. En IVA: por bien y servicio	- En Renta: por modalidad - En IVA: por bien y servicio según deciles de ingreso	Por tributo según sector económico y modalidad	- Por tributo (según modalidad y sector económico)	- Por sector beneficiario según alcance geográfico, modalidad y tributo

Source: ECLAC based on official information.
1/ Estimations do not consider the effect of the elimination or reduction of the tax benefit on the economy of the activities affected and their future continuity or level.

In the specific case of **Argentina**, beginning in 2006, a long-term approach is introduced for the definition of tax expenditure, considering exclusively the cases that occasion final revenue losses. This entails that the regimes allowing for tax deferrals are not deemed tax expenditure, and neither are accelerated amortization in Income Tax and the advance refund of VAT credits[14]. In identifying tax expenditure cases, the structure of each tax established in the applicable legislation is deemed the benchmark, considering the cases benefiting from a special treatment. The estimations for this country, just like in the majority of the countries of the region, do not consider the effect of the potential elimination or reduction of the tax benefit on the economy of the activities involved and their future continuity or level, but it does calculate the tax evasion rate for each tax.

It is worth mentioning that **Brazil** implemented a change in the definition of the notion of tax expenditure beginning in 2004, when the term tax benefit was replaced by tax expenditure. This new definition incorporates the tax expenditure likely to be replaced with direct expenditure tied to government programs.[15]

Chile employs an ex-post measurement in the tax expenditure calculation and follows a cash flow assessment. Additionally, different from the rest of Latin American countries, the assumption of a change in taxpayer behavior is applied: the assumption of constant total expenditure[16], but the changes of behavior of the tax authority or the level of tax evasion are not considered. Additionally, another two aspects in the Chilean methodology are different from those applied in Argentina and Brazil. On the one hand, the estimations of the Chilean case include tax deferrals and accelerated amortizations in the Income Tax. On the other hand, a consumption-type VAT is defined in the VAT, which levies the total domestic sales and imports of goods and services at a single tax rate, while in Argentina the benchmark is limited to the tax structure defined in the applicable legislation[17].

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[14] *Calculations of tax expenditure according to this long term approach have been available since 2005.*

[15] *For more details, refer to the Methodological Annex.*

[16] *According to this behavior assumption, the annulment of an exemption translates into a lower disposable income for taxpayers, and therefore, less consumption. Then, if consumption drops, VAT collection also drops, which partially mitigates the gross effect of annulling the exemption.*

[17] *For example, the calculation of tax expenditure applied to VAT in Argentina does not consider the services exempted or excluded in the list of the services levied by the tax (Art. 3º of the Law) since they are not deemed part of the purpose of the tax (retirement and life insurance and contracts with Labor Risk Insurers).*

With regards to **Colombia,** the main methodological difference lies in the calculation of the tax expenditure in the VAT, since, on the one hand, it only takes into account the exclusions and exemptions defined in legislation without considering the large number of differential tax rates existing in the country. On the other hand, estimations show that the increase in terms of collection would occur if such products were levied at a 1% tax rate[18]. Calculations entail a 25% tax evasion rate approximately, for the average tax evasion in recent years.

In **Ecuador**, a distinctive feature is the presentation of VAT tax expenditure according to income deciles and by type of goods and services simultaneously. Nevertheless, this country applies fewer types of tax expenditure than the rest of the countries analyzed, since it only calculates the revenue loss owing to the existence of VAT-exempted products and special Income Tax exemptions and deductions.

On the other hand, we may state that the definition of the basic rule in **Guatemala** is broader than the one adopted in other countries in the region, which would entail higher tax expenditure with respect to other Latin American countries.

Some examples of this broader benchmark are: the inclusion of a personal deduction for employees; exemptions granted to State agencies and their departments; exemptions for diplomatic missions and international agencies and the tax waiver from Free Trade Agreements and Partial Scope Agreements.

Although **Mexico** also applies the ex-post method, it differs from other countries since it applies the accrued basis. Additionally, different from Argentina and Brazil, it does not adopt a long term approach, by which estimations include tax deferrals. On the other hand, VAT considers as the normal scheme a consumption-base VAT and with regards to Corporate Income Tax, the normal structure is defined as the one applied according to the principle of worldwide income.

Lastly, **Peru** considers almost all central government taxes as well as a broad array of types of tax benefits. Just like in the rest of the countries of the region, the methodology employed in calculations is the revenue loss or ex–post method. In turn, most of the calculations are made independently, assuming that the rest of the tax structure remains in effect without modifications with respect to the base tax system.

[18] *It is important to highlight that in the Colombian tax system there are currently eight differential VAT rates, which range from 1.6% and 35.0%, the general rate being 16%.*

4.3. Quantification of Tax Expenditure in Latin America

As we analyzed in the foregoing section, the information on tax expenditure involves numerous conceptual complications that distinguish it from the information relative to direct tax expenditure, against which they are compared. The discussion vis-à-vis the most appropriate normal tax structure, the different taxes included, the different methodologies employed as well as the interaction among the different measures suggests that the tax expenditure information shall not be compared among countries and be examined within a given context and based on generally accepted tax policy principles.

In such regard, Table 2 is included solely to render an idea on the magnitude of the tax expenditure in many of the countries in the region, in terms of GDP as well as with regards to the overall revenue.

Table 2: Tax expenditure in selected Latin American countries. Year 2007 [a/]
(In percentage of GDP)

	Argentina		Brazil		Chile		Colombia b/		Ecuador		Guatemala		Mexico		Peru
IT	0.51	1	.11	4	.21	1	.60		1.20		5.28	3	.13		0.29
- CIT	…		0.45		0.90	1	.36		0.40	…	1		.87		0.10
- IIT	…		0.66		3.31	0	.24		0.80	…	1		.26		0.18
VAT	1.14		…		0.76		1.92		3.40	1	.96		1.94		1.44
Other taxes	0.58	1	.18		…		…		…		0.66		0.31	0	.32
Total Tax Expenditure	2.21	2	.29		4.97	3	.52		4.60	7	.91	5	.38		2.05
TE Corporate Income / Total TE	…		19.7%		18.1%	3	8.5%		8.7%		…		34.8%		5.0%
Tax Pressure	24.9	2	5.1	2	0.2		16.0		13.0		12.5		11.7	1	7.2
Total GT /Total TP	8.9%		9.1%	2	4.6%		22.0%	3	5.3%		63.5%	4	6.0%		11.9%

Source: ECLAC based on official information.
a/ Data for Ecuador belong to 2005 and for Peru, estimations for the year 2008; total tax pressure refers to Central Government and includes Social Security.
b/ The VAT TE is calculated in official sources at a 1% tax rate and adjusted according to the general rate in effect.

5. FINAL REMARKS AND FUTURE CHALLENGES

The developments presented herein are based on the premise that beyond their growth in recent years, the rate of investment of the countries in the region is still insufficient to ensure sustainable growth.

Therefore, as we repeatedly emphasized in this paper, the need to strengthen the level of investment in the region stresses the validity of an effort to assess the cost-effectiveness of tax incentives' policies.

We have presented the different points of contact between tax policy and investment. As we mentioned, the evolution of public investment has been extremely variable and strongly tied to the recurring tax crises affecting the countries in the region.

They have preferably resorted to tax exemptions as an investment promotion policy, different from the other regions where countries have applied subsidies or subsidized loans.

Such incentives, although they were initially aimed at promoting investment and FDI and included mainly Corporate Income Tax, diversified their objectives in time, to the extent they broadened the exemptions to include new taxes.

The magnitude of tax expenditure in the different countries, which are significant beyond the methodological calculation differences, leads to the question on the effects produced by such incentives' schemes, as well as the lack of specific analyses on this aspect, which requires initiatives to strengthen pertinent quantifications and studies.

Additionally, the differences in the methodologies applied in each case (taxes included, scope, type of tax expenditure, calculation methodology) render the comparison among countries inaccurate. To enable such comparison, we need to pursue homogeneous definitions and methodologies.

As we highlighted herein, countries have struggled with tax quantifications of the tax incentives based on tax expenditure. This enables to endow the Tax Policy with greater transparency and to the extent that tax expenditure information is available in a more disaggregated format, whether by tax, sector of activity and/or target regions, it will be possible to assess whether such incentives are more or less effective to attain the policy objectives than the use of other instruments such as subsidies and direct spending.

6. METHODOLOGICAL ANNEX

I. ARGENTINA

Source:

Message of the Bill of the National Administration Budget.

Tax Expenditure Definition:

Tax expenditure is the revenue amount that the Administration ceases to collect by granting a tax treatment that is different from

the one established in general terms in the tax legislation, with the purpose of benefiting certain activities, areas, or taxpayers. The most usual cases are exemptions, deductions of the tax base and lower tax rates.

Frequency:
Annual.

Scope:
National Public Sector (national taxes plus Social Security).

Taxes Included:
VAT, Income Tax, Social Security contributions, Fuels, Foreign Trade, Personal Property, Domestic Taxes, and Minimum Presumptive Income.

Types of Tax Expenditure:
Exemptions, deductions, lower tax rates, economic promotion regimes, payments with bonds or tax credit certificates.

Methodology:
In 2006, the long term approach is introduced to define tax expenditure, exclusively considering the cases that cause final revenue losses. This entails that the systems that grant tax deferrals, accelerated amortization of Income Tax and the advance refund of VAT tax credits.

For the identification of tax expenditure, the benchmark is the structure of each tax established in the respective legislation –its purpose, tax rates, general deductions, assessment method, etc.-, subsequently pointing out the cases in which, being included therein, are benefited by a special treatment.

Calculations do not consider the effect of the elimination or reduction of the tax benefit on the economy of the activities involved and on their future continuity or level, but they do consider the tax evasion rate for each tax.

In the case of Income Tax, the most relevant current deductions are not considered owing to their general nature (exempted minimum, special deductions for personal work, family allowances, and contributions to HMOs, private health plans and retirement systems).

As regards VAT, the services exempted or excluded from the enumeration of the services included (Art. 3º of the Law) were not considered tax expenditure because they are included in the purpose of the tax (retirement and life insurance and contracts with labor risk insurers). On the other hand, the exemptions in Article 7º of the Law generally form part of such expenditure. The exemption or reduced tax rate applied on goods and services used as raw materials are not deemed tax expenditure, since the tax assessment system levies them in the following stage, at the rate effective therein.

With regards to specific taxes on consumption, the assets levied are exclusively deemed included in the purpose of the tax. Therefore, tax expenditure is defined as the tax treatment difference for substitute goods or services. This is the criterion adopted with non-alcoholic beverages (with and without fruit juice) and in fuels (gasoline, diesel and compressed natural gas).

With regards to Social Security contributions, the loss of revenue arises mainly from the difference between types of employers' contributions in the Federal District and the rest of the country.

Presentation of calculations:

The results are presented in totals and according to the following classification:

- By tax:
  - According to their origin (tax laws or promotion systems).
  - According to modality (exemptions, deductions, lower tax rates).
  - By economic promotion system per tax.

II. BRAZIL

Source:

Report of Indirect Government Expenditure of a tax nature (Tax Expenditure).

Definition of tax expenditure[19]:

Tax expenditure is indirect government expenditure made via the tax system to address economic and social objectives. They are defined in the tax regulations, constituting an exception to the benchmark tax system, reducing potential collection and consequently, increasing the taxpayer's disposable income. They are compensatory in nature when the government fails to adequately provide the services to society for which it is responsible, or centered on promotion when the government seeks to foster the development of a certain sector or region.

Frequency:

Annual.

Scope:

Central Government (federal taxes, Social Security is not included).

Taxes Included:

Imports' duties, Income Tax (IIT, CIT and source withholdings), industrialized products, financial operations, rural real-estate property, Corporate Tax for PIS-PASEP, Corporate Tax on liquidated profit, Social Security financing contribution (Cofins, as per the Portuguese acronym). The tax on the circulation of goods and services (ICMS, as per the Portuguese acronym), a state tax, is not included.

Types of Tax Expenditure:

Exemptions, pardons, deductions, differential tax rates, free trade areas, support or promotion programs.

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[19] *This definition was adopted after the 2004 report, substituting the term "tax benefit" by "tax expenditure". This is so because the notion of tax benefit did not fit into the budgetary approach, and, consequently, certain tax benefits did not meet the notion of tax expenditure and vice versa. With the adoption of this new notion, the following have been excluded since 2004: Lojas Francas, Bagagem Acompanhada, Promotional Material, Alienação de Bens de Pequeno Valor, Lucros and Dividendos Recebidos da PJ, Atividade Rural and Dedução para Dependentes do IRPF. The items included are: Entidades Sem Fins Lucrativos, Despesas Operacionais do IRPJ (com FAPI, PAIT, Assist. Médica and Odontológica and Pesquisas Científicas) and Automóveis para portadores de Deficiência Física.*

Methodology:

As from 2004, the term “tax benefit” was changed to “tax expenditure” and the following two-step rule is used in identifying tax expenditure:

1º) All the tax concessions are determined on the basis of a benchmark tax system.

2º) An assessment is conducted according to the criteria defined in the notion of tax expenditure, in which exemptions are indirect expenditure that may be replaced by direct expenditure tied to government programs.

Lemgruber (2002) highlights some of the examples excluded from the notion of tax expenditure:

✓ Tax deferrals are not deemed tax expenditure because they are not considered a final revenue loss. That is to say, there is only a delay in the tax payment, so the condition of a potential reduction in revenue and the taxpayer’s disposable income, as explained in the definition of tax expenditure, is not met.

✓ Differential tax rates in selective taxes (such as the tax on industrialized products) or regulatory taxes (import duties) are not considered either, since they constitute an exception to the benchmark tax system.

✓ Exemption from imports’ tax and tax on industrialized products for Information Technology assets acquired by the Higher Electoral Court, aimed at electronic voting, are not deemed tax expenditure because the government is the inherent beneficiary.

Presentation of calculations: the results are presented in totals and according to the following classification:

- By tax:	- According to modality.
	- According to region.
- By budgetary function:	- According to modality.
	- According to region.

III. CHILE

Source:

Report on Public Finances. Bill on Public Sector Budgets, Tax Expenditure Chapter.

Tax Expenditure Definition:

Tax expenditure is the revenue amount that the Administration ceases to collect by granting a tax treatment that is different from

the one established in general terms in the tax legislation, with the purpose of benefiting certain activities, sectors, branches, regions or groups of taxpayers.

Frequency:

Annual.

Scope:

Central Government.

Taxes Included:

Income Tax (Individuals and Corporations) and VAT.

Types of Tax Expenditure:

Tax exemptions or deductions, differential tax rates, deferrals, accelerated amortizations, special regimes and tax credits.

Methodology:

An ex-post measurement, that is to say, based on effective information for a period that already lapsed and a cash flow assessment is applied (analogous to the one employed in the development of the Budget). Additionally, the assumption of a change in taxpayers' behavior is applied: the total constant expenditure assumption. Pursuant thereto, the annulment of an exemption translates into lower disposable income for taxpayers and, therefore, less consumption. Then, if consumption drops, VAT collection also drops, which partially mitigates the gross effect of annulling the exemption.

The TE figure for year t measures the additional revenue amount that would be collected in year t if a given exemption were not applied.[20] Measurements of each tax expenditure item are performed individually, that is to say, assuming that the remaining exemptions remain unchanged. The changes in the behavior of the tax authorities or in the tax evasion level are not considered either. Nevertheless, the total tax expenditure line items incorporate the joint or simultaneous exemption effects.

In the case of Income Tax, the taxable income is deemed the income definition set forth in the Income Tax Law proper. Special systems for small taxpayers as well as the simplified accounting

[20] *For more details on the methodology, refer to Jorrat (2006).*

system for taxpayers with rural real estate property under the forestry law are deemed part of the norm, since their ultimate objective is to facilitate tax compliance. On the other hand, the presumptive income systems and withdrawal-based taxation are not part of the norm, since both produce tax relief to the pertinent parties.

On the other hand, vis-á-vis VAT, a consumption-type VAT norm is defined, which applies a single rate on the total domestic sales and imports of goods and services. The zero rate applied on exports and exemptions arising from conventions or international exemptions (for example, imports from diplomatic representations, international agencies, personal belongings of immigrants, etc.) are deemed part of the norm.

Presentation of estimations: the results are presented in totals and according to the following classification:

- By tax according to modality.
- By sector or objective benefited.
- By most relevant items.

IV. COLOMBIA

Source:

Bill for the General National Budget. Presidential Address and the Middle term Tax Framework.[21].

Tax Expenditure Definition:

Tax expenditure is the designation for the revenue the Administration ceases to collect given the existence of special tax treatments (exceptions, exemptions, tax credits, among others) in the tax system.

Frequency:

Annual.

Scope:

Central Government.

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[21] *Article 87 in Act No. 788, of 2002 established the government obligation to present "a detailed report evaluating and explaining the tax impact of the benefits ...", emphasized by defining rules for tax transparency and macroeconomic stability, pursuant to Act No. 819 of 2003, which sets forth that the middle term tax framework shall include, among other elements, "an estimation of the tax costs of exemptions, deductions or tax discounts in place."*

Taxes Included:

Income Tax (Individuals and Corporations) and VAT.

Types of Tax Expenditure:

Vis-à-vis Income Tax, the deduction is considered based on the investment in real productive fixed assets, exempted income and tax discounts. VAT considers the exclusions and exemptions.

Methodology:

In the case of the Income Tax, the tax cost of the tax benefits seeks to assess the National Government's revenue loss as a result of the benefits applied. Thus, in calculating such cost, the tax amount that would have been collected should the requested benefit have been part of taxpayers' taxable income is defined.

Calculations do not include the reaction of taxpayers before an eventual annulment of the benefit. The case may be that, for example, upon eliminating an exemption, another one may be applied, which had been limited by the convergence of benefits or that taxpayers tend to adjust to their tax planning, and the tax cost calculation could be overvalued.[22]

On the other hand, vis-à-vis Value Added Tax, tax benefits are deemed the exclusions and exemptions in effect in Colombian legislation, except those arising from international conventions and diplomatic reciprocity, as well as goods for export.[23]

The results of tax expenditure in the VAT are presented as the revenue effect by rate point for exempted and excluded goods and services. That is to say, it shows the increase in terms of collection that applies, should these products be levied at a 1% rate[24]. Calculations imply a 25% tax evasion rate, approximately, for the average collection in the last few years.

Presentation of calculations: the results are presented separately for Income Tax and for VAT. In the case of the former, they are classified as follows:

- Type of benefit: deduction, exempted income and tax discounts.

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22 *DIAN, Office of Economic Studies, Working Papers: "Tax benefits in Colombian Income Tax. Fiscal year 2004", Colombia, June 2005.*

23 *Nevertheless, the definition of tax benefit or tax waiver is not very clear, owing to the existence of differential rates for certain products and excluded and exempted assets.*

24 *Currently, the Colombian tax system applies eight differential VAT rates, which range from 1.6% and 35.0%, with a general 16% rate.*

- Taxpayer modality: Individuals and Corporations.
- Type of taxpayer: taxpayers, non-taxpayers and special regimes.
- Economic sub-sector: 17 or 18 groups.

In VAT, the results are presented per asset or service exempted or excluded.

V. ECUADOR

Source:
Tax Expenditure (Department of Fiscal Studies, SRI).

Tax Expenditure Definition:

Tax expenditure is the transfer made by the State to certain groups or sectors, which are not materialized via tax expenditure, but a reduction in taxpayer's tax obligation. That is to say, by tax exemptions, special deductions and reductions in the tax rates as well as tax deferrals.

Frequency:

Annual.

Scope:

Central Government.

Taxes Included:

Income Tax (Individuals and Corporations) and VAT.

Types of Tax Expenditure:

Products exempted from VAT and special exemptions and deductions in the Income Tax.

Methodology:

The method employed is determining the revenue that would be collected should a benchmark system be applied, that is to say, if VAT were levied on exempted products or special Income Tax exemptions and deductions were annulled.

As regards the calculation of the tax expenditure in the VAT, in general, the information on the Standard of Living Conditions for 2005 was used, applying the current VAT rate on the expenditure in exempted goods and services.

The following items are included in the tax expenditure calculation in the Corporate Income Tax: reinvestment of earnings, amortization of tax losses from previous fiscal years, deductions from special laws and double taxation agreements. In the case of the Individual Income Tax, the tax expenditure is made up by the exemption of the financial yields, by the exempted bracket for professionals and the exempted bracket for employees.

Presentation of calculations: the results are presented in totals and pursuant to the following classification:

- Income Tax: according to modality (separately for Individuals and Corporations).
- VAT:
  - According to types of assets and income deciles.
  - According to type of services and income deciles.

VI. GUATEMALA

Source:

Report on the Tax Expenditure of the Bill on the General State Revenue and Outlays[25].

Tax Expenditure Definition:

Tax Expenditure originates in the preferential tax treatments, exemptions, exceptions, waivers, special deductions and other measures foreseen by tax legislation, which enable certain social groups to reduce the tax burden and constitute an exception to the tax laws in effect for taxpayers in general. The term “Tax Expenditure” refers to the State’s revenue loss arising from special tax treatments and is equivalent to the amount that would have been allocated and transferred to a group or sector in particular to promote their activities.

Frequency:

Annual.

Scope:

Central Government.

[25] *Since the year 2000, the Superintendency of Tax Administration (SAT, as per the Spanish acronym) has been conducting a calculation of Tax Expenditure in response to the commitments of the Fiscal Agreement.*

Taxes Included:

Income Tax, on financial products, extraordinary tax in support of peace agreements, VAT, Import duties, Tax on the distribution of oil and oil byproducts, tobacco and byproducts, Tax on the distribution of beverages, the circulation of vehicles and sale of cement.

Types of Tax Expenditure:

Exemptions, deductions, tax credit, exceptions, annulment of duties, free trade agreements, TARIC.

Methodology:

Quantification of tax expenditure reflects a calculation of the revenue loss for each calendar year, as a consequence of the benefits foreseen in tax legislation. It is not an estimation of the revenue increase that would occur by the elimination of the special treatments analyzed, since such elimination would entail a response from the economic agents, who would cease to conduct certain activities to shift to others, which, in absence of preferential treatments, would result more attractive.

In the case of Income Tax, the personal deduction of Q.36.000 is included for employed workers as tax expenditure, different from other countries where such amounts are excluded on the grounds of the broadness of the benefit. In Guatemala, the only individuals entitled to this deduction are employees, while the individuals devoted to corporate activities do not benefit from this deduction. Therefore, the argument is that this tax benefit is not general and is included in the applicable calculations[26].

Although it may be argued that the exemptions granted to State agencies and their agencies do not represent a tax waiver for the country, since in the latter case, they are extended to the Government proper, they have been included in the tax expenditure calculations for the Income Tax as well as the tax on financial products and the circulation of vehicles.

In the case of the VAT estimation, it is not deemed that tax expenditure exists in the exports of goods and services, as well as in the corporations under *maquila* and free trade regimes, on the grounds that the final generating event for VAT is consumption.

[26] *In 2005 and 2006, this deduction accounted for 47% and 49% of the tax expenditure in the Income Tax of Guatemala.*

On the other hand, exemptions for diplomatic missions and international agencies have been included as tax expenditure in VAT, Income Tax, Tax on Tobacco, distribution of beverages, circulation of vehicles and distribution of cements.

For the purpose of tax expenditure on import duties, the revenue loss based on the special treatment for certain types of imports from selected countries that constitute an exception to the general rule defined by the Central American Uniform Duties' Code (CAUCA, as per the Spanish acronym) is deemed tax expenditure. Therefore, the tax waiver tied to exceptions, TARIC, exemptions to specific entities, Free Trade Agreements and Partial Scope Agreements, form part of this calculation.

Presentation of calculations: the results are presented in totals and according to the following classification:

- By tax:
  - By economic sector.
  - According to modality.

VII. MEXICO

Source:

Tax Expenditure Budget.

Tax Expenditure Definition:

The notion of Tax Expenditure refers, in general terms, to the revenue loss of the Federal Administration arising from differential tax rates in different taxes, exemptions, subsidies and tax credits, special treatments and systems defined by the different federal tax laws.

Frequency:

Annual.

Scope:

Federal Government.

Taxes Included:

Income Tax (IT), Corporate Single Rate Tax (IETU, as per the Spanish acronym), Value Added Tax (VAT) and special levies (Special Tax on Production and Services - IEPS, Tax on New Motor Vehicles - ISAN and Tax on the Ownership and Use of Vehicles - ISTUV).

Types of Tax Expenditure:

Exemptions, deductions, differential tax rates, subsidies and tax credits, deferrals, pardons, facilities, promotions, incentives, special treatments and systems.

Methodology:

In order to draft the Tax Expenditure Budget, the following definitions of the normal tax structure are considered as benchmarks[27]. As regards Corporate Income Tax, the normal structure is deemed the one applied under the principle of worldwide income and in the case of the Individual Income Tax, we apply a global system of income, broad base, zero exceptions, progressive rate and exemption of income up to an amount equivalent to a minimum salary. The normal system considered in the VAT is a broad-based, uniform-rate VAT, without exemptions and applying zero rate only on exports. Special or selective excises deem the normal structure the one applied at a broad-based, positive ad-valorem rate, whose effect shall be equivalent to that of levying all the stages in the production and marketing chain.

The calculation used is the revenue loss (ex-post method), on an accrued basis. Calculations seek to prove the revenue loss for a year without considering the effects of such policy in future years. Therefore, a tax deferral is included as the revenue loss in the year in which the deferral is applied, without considering that this shall be reversed in the future.

Likewise, calculations are made independently and do not take into account the effect of annulling a treatment on the revenue loss of another one.

Presentation of calculations: the results are presented in totals and according to the following classification:

- By tax: - According to modality.
  - According to economic sector.

VIII. PERU

Source:

Multi-annual Macroeconomic Framework.

[27] *For further details, refer to the Tax Expenditure Budget 2008.*

Tax Expenditure Definition:

Tax expenditure is the tax waiver or shifts from a base tax system, which governments employ to reach certain economic and social objectives. A number of tax instruments may be included: credits, exemptions, exceptions, tax rate reductions, deductions, deferrals and refunds, among others.

Frequency:

Annual.

Scope:

Central Government.

Taxes Included:

Income Tax (CIT as well as IIT), General Sales Tax (GST), Selective Excise Tax (ISC, as per the Spanish acronym), Value Added Tax, special duties, surcharges and Tax for Children in Need (ISND, as per the Spanish acronym).

Types of Tax Expenditure:

Exemptions, deductions, differential tax rates, refunds, deferrals, exceptions, credits, free trade areas.

Methodology:

Calculations follow the French practice that considers tax expenditure any tax measure resulting in a revenue loss for the State and the applicable reduction in the taxpayer's tax burden, which would not have occurred had the general tax law been applied.

Thus, the methodology employed in calculating the tax expenditure is the revenue loss or ex–post method, since the methodological criterion adopted is the calculation of the potential tax expenditure' base. In other words, we consider the annual impact for the lower revenue owing to the enforcement of a given tax benefit.

Most of the calculations are performed independently, assuming that the rest of the tax structure in place shall remain unchanged vis-à-vis the base tax system.

Presentation of estimations: the results are presented in totals and according to the following classification:

- By beneficiary sector: pursuant to the geographic scope, modality and tax.

TOPIC 2

CRITICAL TAX CONTROL ISSUES

Lecture

Topic 2

CRITICAL TAX CONTROL ISSUES

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CONTENTS: Summary.- I. Tax havens. - A. Problems detected.- B. International actions.- 1. The efforts in the framework of the OECD: an incentives' policy for greater transparency.- 2. Initiatives in the European Union.- C. Internal actions.- 1. Access to banking and financial information.- 2. Anti-abuse mechanisms.- D. Conclusions.- E. Outlooks.- II. Reestructuring multinationals.- III. The informal economy.- IV. Conclusions

SUMMARY

Tax control ensures tax compliance. Its role is vital in combating tax fraud that jeopardizes public finances and impairs the social contract.

Recent advancements in the economic, social and technological fields constitute numerous new opportunities for fraudsters. Internationalization of business, increasing mobility of economic actors and capital, virtualization of transactions, -mainly in the banking sector-, and the emergence and role of the Internet are new challenges that the Administrations shall address appropriately.

The French Administration, as well as its partners, is faced with such issues. Three relevant topics seek to illustrate the difficulties and challenges ahead:

- The role of tax havens in tax evasion that leads to concealment of wealth and income for individuals as well as corporations;

- Relocations by multinationals who, with the excuse of a legal reorganization, transfer their benefits to low taxation areas and

resort to taxation for an economic leverage effect, since the tax is a cost they seek to reduce;

- The informal economy, which calls for a uniform approach by all the State agencies, in which the Tax Administration plays a key role.

If the French Administration participates in such affairs with its control and investigation tools and anti-abuse mechanisms, the balance reached shows the need to constantly adapt the means employed and a global approach towards these challenges.

The schemes based on the use of tax havens are not new to the Administration. Multiple initiatives have been implemented in such respect, internationally, in the field of harmful tax practices as well as the European Community, by the adoption of a Code of Conduct on harmful tax competition and the implementation of the savings directive to guarantee effective taxation of the savings' interest earned by residents of the Union. Internally, the strategy stands on two pillars: the obligation to file tax statements and the anti-abuse mechanisms.

In the light of the recent cases, we must admit that the openness and transparency policy adopted by the International Community was not completely fruitful. This assertion favors a specific approach, based on the effectively cooperative nature of a territory and an improvement of the existing tools, whether the EU Savings Directive or more stringent rules in our internal procedures.

The relocation policy, identified almost a decade ago, acquires such a magnitude worldwide that it hinders the revenue of certain States. A number of such relocations entail changes in the Charter of Incorporation, which are aimed at shifting functions and related benefits to low taxation countries. Such practices are even more difficult to counter, since they are performed under uncertain legal frameworks.

The magnitude of this phenomenon and the complexity of the issues set forth have lead the OECD to implement a working group to provide clear directives. The efforts for the harmonization of Community Law and the elimination of harmful practices should enable to eradicate them in the European Union in the future. Internally, our action is based both on a voluntary ex post tax control policy and initial prevention by ex ante transfer pricing agreements.

To conclude, the harm caused by the informal economy that contributes to criminal organizations of all kinds to the detriment of the State and citizens, justifies its priority for the State and, specifically, tax control.

Our action is based on the information gathered by the exclusive internal and inter-ministry services and specific procedures, but could be further enhanced by a better coordination of the State agencies and the communication regarding the consequences of tax fraud.

Beyond these three issues, the focus on the struggle against tax fraud is based on two action courses of the Administration: facilitating tax compliance to enable better acceptance of the tax, on the one hand, and maintaining an active tax control policy to punish fraud, on the other.

Tax fraud or, in broader terms, lack of tax compliance, is not anodyne at all. It reduces the resources available to finance public policies, creates competition distortions and inequitable treatment to the detriment of honest taxpayers who feel legitimate unfairness and dissatisfaction.
Tax fraud hinders an individual's perception of a fair system and reduces the benefits of competitiveness. It affects all taxpayers and all taxes. Its expansion poses a real danger for the social and economic cohesion of our countries.

The struggle against tax fraud is a great responsibility, burdening the tax administrations. Therefore, in France, tax control is deemed to secure tax compliance.

The key issue is to define priorities to be assigned to the control services as well as identify the most relevant or critical risks to be prevented by their actions.

In a business internationalization context, the increasing mobility of economic actors and capital, virtualization of transactions, chiefly in the banking sector and trade and, in Europe, the removal of border controls and the free circulation of individuals, goods and capital, three key issues concern the French Administration in the present, among others:

- The crucial issue of tax havens. In Europe, a recent case revealed how such territories enable the diversion of very significant amounts;

- «Relocations» or « business restructuring ». This issue is not new, since this phenomenon exists since the 90s, but is currently gaining momentum;

- And the informal economy thriving in our territories, mainly owing to the use of the Internet.

These three aspects are not the only ones concerning the French Administration. Just like their partners in the European Union, it shall also face, for example, a relevant VAT-fraud arising from trade within the EU (VAT carrousel fraud, fraud with second-hand-vehicles).

We shall present the French approaches to these three big challenges and the legislative as well as organizational improvements considered for the future.

I. TAX HAVENS

A very relevant and publicized case recently illustrated the issue of tax havens and, mainly, the important shifts of wealth that were concealed, enabling to identify the difficulties of States' in detecting such fraud aided by the traditional means available.

It was verified that the residents of several States, including France, owned significant assets in Liechtenstein, via shell companies, and neither such income nor the proceeds arising from their placement were filed with the tax administrations.

Nevertheless, in addition to its magnitude, it is a classic case of equity investment by assimilated associations or structures in a tax haven that all countries are potentially faced with.

Concealment of wealth and income facilitated by accounts protected by bank secrecy combined with low, or even zero taxation for non-residents, are the normal advantages tax havens offer.

Such practices are largely facilitated by the absence of Exchange controls, internationalization of trade, modern means of communications and distance management of bank accounts and virtualization of currency and payments.

A. PROBLEMS DETECTED

- For individuals, tax havens enable to avoid not only Income Tax, but also inheritance or personal wealth taxes.

The use in these territories of legal instruments such as trusts, foundations or national trusts, which blur the ownership of wealth, disrupt legal ownership from beneficial ownership and avoid the subjection to taxes of the assets owned and the income they produce.

To conceal income from a business activity, tax fraud may be perpetrated by the creation in such territories of a shell company, lacking substance, in charge of receiving the income corresponding to the remuneration of the services rendered by an individual or the exploitation of intellectual property or image rights thereof. Examples are companies who manage the image of high-competition athletes, which enables them to earn a concealed salary by establishing themselves in such territories.

- For corporations, we particularly verify the following situations in which they take advantage of tax havens:

  - The fictitious domicile of a corporation in a tax haven while the effective management address is registered in France. In order to effectively combat this type of fraud, we must rely on material evidence that is frequently obtained only by searching the corporation;

  - Direct or indirect transfers of income by the reduction of income or increase of tax burdens, even by creating undue expenses in order to duly place income in the company installed in a low taxation country. We chiefly verified the artificial increase of payments for services, fees, interest, royalties, whose status and fair price are particularly difficult to control, mainly in the case of intangible services;

  - The use of a stepping stone company in a country with weak taxation level, managed and controlled by a corporation based in France. Interchanging it in the normal operations of the group enables the artificial location of a portion of the margin. For example, for purchase-resale activities, the stepping stone company may be used to buy products from the headquarters in order to sell them to affiliates of the group, capturing the benefit in the tax haven.

B. INTERNATIONAL ACTIONS

Tax havens are not a new issue. States quickly became aware that the struggle against tax evasion in this sphere required global and concerted action.

France's efforts are supported by the initiatives undertaken in 1996 jointly in the Organization for Economic Cooperation and Development (OECD) and the European Union (EU), which seek to combat harmful tax competition.

1. The Efforts in the Framework of the OECD: An Incentives' Policy for Greater Transparency

In 1998, the OECD published a report on harmful tax competition, which determines the existence of preferential tax regimes in some OECD-Member States[1] and practices in numerous non-OECD territories and States that would qualify them as tax havens[2].

With regards to the latter, the OECD announced the creation of a list of States and territories against which its members would be invited to enforce retaliation measures (anti-abuse mechanisms, etc.).
In the year 2000, it published a report on the progress in the identification and elimination of harmful tax practices, resulting in a list of 35 States or territories that met the criteria of tax haven[3].

The OECD sought tax havens to assume commitments in terms of transparency and information exchange. A model Information Exchange Agreement was adopted, with the consensus from OECD countries and tax havens, which addressed tax fraud as well as tax evasion.

In exchange for this commitment, they were offered the adhesion to the World Forum, the exclusion from the list, exemption from the

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[1] *47 harmful regimes were identified later, then dismantled by a «Forum on Harmful Tax Competition» created with the sponsorship of the OECD Fiscal Affairs Committee and chaired by France.*

[2] *Four criteria were agreed: almost absence of direct taxation, scarce local economic activities, opacity of the applicable and applied tax regulations, and lack of information filed to the tax administrations of other countries.*

[3] *Another six (Bermudas, Cayman Islands, San Marino, Mauritius, Cyprus and Malta) were not mentioned since they had already assumed a commitment in terms of transparency and information exchange (see below).*

application of any coordinated framework of defensive measures, and the certainty that the non-cooperating jurisdictions would be uniformly subject to such a framework.

Certain that they would continue being attractive for their low taxation level and concerned about being included in a black list of non-cooperative countries, 32 States or territories promised to apply greater transparency. Firstly, they would remove bank secrecy vis-à-vis tax fraud, and then tax evasion, or modify their legislation so they would no longer be considered tax havens. Currently, this list comprises only three territories: Andorra, Liechtenstein and Monaco.

Since then, Australia, the Netherlands, the United Kingdom and Nordic countries subscribed a number of information exchange agreements with very few tax havens. France plans to subscribe at least two agreements.

2. Initiatives in the European Union

At the European level, a first series of efforts enabled the adoption by every Member State in 1997 of the Code of Conduct on harmful tax competition.

Then, in 2003, so that certain Union residents would no longer avoid taxation on the interest earned in another Member State, the council adopted Directive 2003/48/EC of June 3rd, 2003 on taxation of savings income in the form of interest payments.

a) The Code of Conduct.

By adopting the Code of Conduct in 1997, Member States promised to eliminate the tax measures in place that foster harmful tax competition («dismantling») and to refrain from introducing any new measure with such effect («freezing»).

This code refers to the measures that have, or may have, a sensitive incidence on the localization of economic activities in the European Union, such as those foreseeing an effective tax burden clearly lower than the general one applied in the pertinent country, tax advantages reserved to non-residents, tax incentives in favor of activities unrelated to the local economy, so they do not impact the national tax base, granting tax benefits even in the absence of any effective economic activity, rules to determine the income of corporations that form part

of a multinational group that depart the generally applied international rules, mainly those approved by the OECD.

A report from November 1999 gathered 66 tax measures that present harmful elements (40 in the EU Member States, 3 in Gibraltar and 23 in the dependent or associated territories).

Member States and their dependent or associated territories currently corrected or replaced these 66 measures or are about to do so. For the entities that benefited with such regimes until December 31st of 2000, a clause on acquired rights was set forth, according to which their benefits had to be discontinued as of December 31st of 2005, whether agreed for a given term or not. For certain measures in effect in the Member States and their dependent or associated territories, limited extensions were agreed beyond 2005.

Since then, the «Code of Conduct» group guarantees to monitor the freeze and the implementation of the dismantling effort, and regularly reports to the Council.

b) The Savings' Directive: a specific information exchange instrument on interest among financial centers outside of the EU.

Taking advantage of the free circulation of goods, certain residents of the Member States avoided any form of taxation on interest earned in another Member State, other than their State of residence, creating a distortion in the effective taxation of the income from savings.

Additionally, it fostered tax evasion on the income from savings and stressed the tax pressure on income from a less mobile source, such as the income from work, with a detrimental effect on the cost of the latter, and thus, indirectly, on employment creation.

In order to close the issue, as from July 1st, 2005 the Directive organizes a system that enables taxation in the State of residence of the interest paid by a paying agent to an individual resident in the State of the Community, called the effective beneficiary. This system foresees:

- The principle of disclosure by the Member States of the payments in the form of interest made by paying entities in favor of individuals who are effective beneficiaries residents of the Member States (information exchange);

- Exceptionally, applying a source withholding during a temporary period in the 3 Member States that do not participate in the information exchange effort since they apply bank secrecy (Austria, Belgium and Luxembourg). The source withholding rate, initially 15 %, is 20% from July 1st, 2008 and shall change to 35% on July 1st, 2011. The paying State withholds 25%.

The source withholding system is also applied in ten dependant or associated countries of the Member States (Anglo-Normand Isles, Isle of Man and dependant or associated countries of the Caribbean) and in five third-party countries from Europe (Monaco, Andorra, San Marino, Liechtenstein and Switzerland).

The temporary source withholding period shall conclude when:

- The Union subscribes an agreement with the five third-party States providing for the exchange of information upon request relative to the payment of interest according to the 2002 OECD Model Convention, such payments continue to enforce source withholdings simultaneously;

- The United States shall commit to exchange information upon request with regards to the interest payment, pursuant to the model convention, with all the EU Member States.

In 2006, France received 580,000 reports– all the information may be used by the agencies - and 50 Million Euros in source withholdings.

C. INTERNAL ACTIONS

Internally, the withholding mechanism tends to obtain, in the first place - or at the spontaneous request of taxpayers or establishments-, banking and financial information that could reveal the use of tax havens.

Concurrently with these measures to facilitate detection, other internal law provisions are aimed at preventing abuses and punishing them with direct focus on the relations of French residents with such territories.

1. Access to Banking and Financial Information

The Administration enjoys the right of disclosure enabling, on the one hand, to obtain banking information from the financial institutions, and

on the other, information on the transfer of funds to foreign jurisdictions, mainly, by individuals.

Tax legislation imposes upon individuals, associations and corporations lacking commercial operations, domiciled or established in France, filing, simultaneously with their income statements, the information on the accounts held, used or closed in foreign jurisdictions. For each bank account that is not filed, a € 750 fine shall apply.

Finally, the law foresees that individuals, who transfer amounts or assets in excess of € 7,600 to foreign jurisdictions without the intervention of banks, are mandated to file them.

In case of noncompliance with these obligations, the law sets forth a presumption of concealment of income vis-à-vis the amounts paid or withdrawn from accounts that have not been filed or transferred without filing the transaction.

2. Anti-Abuse Mechanisms

Such mechanisms establish a tax evasion presumption vis-à-vis entities established in preferential tax regimes.

Tax Legislation Foresees:

- Taxation of the corporation established in France for the income of their subsidiaries or branches established in a country with a preferential tax regime. In the absence of an effective industrial and commercial activity conducted in the country with the preferential tax regime, it reverses, according to certain conditions, the burden of the proof to the detriment of the French companies, since they are mandated to justify an interest other than a tax interest in the location of their income in such territories [Art. 209 B du CGI];

- Taxation of the income of individuals domiciled in France who own more than 10% of the equity of corporations or entities established in a preferential tax regime [Art. 123 bis du CGI];

- Taxation of the service provider established or domiciled in France for the amounts received as service payments by an individual domiciled or established in a preferential tax regime. It is also applied to the service provider domiciled outside of France when the service was rendered in France. This mechanism is aimed at

preventing the use of shell companies to avoid the tax normally enforced in France, mainly by performers and athletes [Art. 155 du CGI];

- That the amounts paid to individuals domiciled or established in a preferential tax regime are not deducted by the businesses established in France unless they provide evidence of the operations that underlie such expenses and that the prices paid are within the normal ranges. This measure is applied to interest, royalties and remuneration for goods and services and all the payments made in an account opened in such States or territories [Art. 238 A du CGI].

D. CONCLUSIONS

- Since the efforts are conducted under the OECD umbrella, recent elements of context confirmed that the current situation was not satisfactory and that the approach from the incentive standpoint, only based on the good will of tax havens had limited effects:

    - Certain jurisdictions still refuse to subscribe transparency and information exchange agreements and thus remain on the OECD list without complaints;

    - Others subscribe agreements that allow them to remain on the list, but do not subscribe information exchange agreements.

The few jurisdictions that abide by their commitments could thus be harmed by the absence of protective measures implemented jointly by the OECD Member States for other territories, in spite of the initial announcements. Additionally, this lack of response does not promote the latter's' cooperation.

- The Savings' Directive mechanism features weaknesses mostly tied to its scope of application. It only covers individuals and a category of financial products and does not include certain important financial centers, mainly Asian. Additionally, it does not provide for the application by all the Member States of an exchange mechanism.

In France, the source withholdings' amount paid by third-party States and associated territories seem to be limited and not very consistent with the total income located therein. On the other hand, Member States do not rely on any means to control the amount withheld at the

source paid thereto. Also, without information on the owners of capital, taxation of net worth is impossible to determine.

- Internally, beyond the anti-abuse mechanisms reviewed recently to adjust them to Community Law, gathering taxpayers' banking information is deemed ineffective (in 2006, only 25,000 accounts opened in foreign jurisdictions were filed for the 35 million tax statements), which seems incompatible with the facts set forth by the foregoing case.

Overall, the conclusions show that the current mechanisms must be improved.

E. Outlooks

1. In the International Sphere, Improve the Existing Mechanisms.

In the international sphere, France considers that it is necessary to pursue and sustain the efforts undertaken.

a) At the OECD level: Privilege a Differentiated Approach.

France supports the initiatives of the OECD Committee on Fiscal Affairs, which decided in the beginning of 2008 to act on two fronts:

- Develop a method to differentiate territories according to their degree of effective cooperation, in order to provide an incentive to the countries that have doubts with regards to subscribing information exchange agreements;

- Undertake a common reflection on the potential retaliation (anti-abuse mechanisms) against the territories that seem to be non-cooperative.

Additionally, a consensus exists to refuse to sign, even report, each tax convention that does not foresee a total and complete exchange of tax data according to the new Article 26 of the OECD Model Tax Convention.

b–In the EU: improve the Savings' Directive.

France, mainly based on the fact that it chairs the EU, sustains very active efforts aimed at improving the Savings' Directive and

the renegotiation thereof, mainly in order to broaden their scope to individuals and other financial products and their extension to other financial centers (such as Hong Kong and Singapore).

Essentially, the modifications required in the Directive would be aimed at:

Broadening the scope of the products covered beyond the classic interest-bearing products, such as non-interest bearing products – byproducts or life insurance– or innovative financial products;

- Better identify the effective beneficiaries of such income in order to avoid concealment aimed at using certain entities, such as trusts, between the paying bank and the final beneficiary to avoid the provisions of the Directive;

- To put an end, as soon as possible, to the temporary source withholdings' regime. Belgium, Luxembourg and Austria would be required to apply the automated exchange of information and, consequently, waive bank secrecy, at least for the non-resident Community citizens.

2. Internal Approach.

Internally, we have identified margins of progress that combine, on the one hand, better taxpayers' information in order to prevent tax fraud and on the other, new action means for the Administration in order to counter the most serious actions.

b) Inform and Prevent.

▪ We are studying a relevant communication campaign to make taxpayers aware of the fact that tax fraud constitutes a genuinely serious crime, which carries potentially serious sanctions for the author. In France, it is truly a novelty.

  As regards tax havens, as recommended by the OECD, this communication initiative could pursue the following objectives:

- Remind the rules vis-à-vis tax territoriality;

- Make taxpayers aware of the risks posed by the jurisdictions mentioned, in absence of a regulation that protects accountholders;

- Encourage taxpayers to preserve their assets in a jurisdiction that applies the OECD standards.

▪ We have also foreseen clarifying the legislation relative to trusts or assimilated entities, structures frequently employed in connection with tax havens but not foreseen by French Law, to establish the net worth taxes based on the French notion of legal ownership (rights to transfers for no valuable consideration and personal assets) adopting a specific and secure legal entity. This clarification would enable to overcome ambiguous construal.

▪ Since the issue is compiling banking information from taxpayers, in addition to being better informed, which is undoubtedly necessary, we are considering a more deterrent penalty amount in case of noncompliance with this obligation. It may vary according to the place where the account has been is opened.

c) Stricter Tax Control Procedures vis-à-vis Anti-tax Fraud Efforts.

We have foreseen two measures:

- Duplication of review terms (6 years) when the taxpayer failed to file the accounts opened in a tax haven or the income or profit from entities based in a tax haven, owned thereby. Limiting the «right to not file» of taxpayers resorting to the advantages of tax havens would enable the Administration to rectify their situation for a longer period. This would also contribute to prevent this type of behaviors;

- The creation of a judicial tax investigation service that set forth prerogatives that traditionally corresponded to the Marshall Service's officers (police surveillance, background checks, telephone tapping, etc.). A portion of the punitive action conducted by the Tax Administration with their administrative procedures would be shifted to the criminal sphere, that is to say, headed by agents of the Administration under the judicial authority, and which rely on more powerful investigation tools. These new powers shall enable to mitigate the weaknesses of the purely administrative anti-tax haven procedures. This vast reform in France could be adopted prior to the end of the year.

II. REESTRUCTURING MULTINATIONALS

The tax strategy is at the core of the financial management of multinationals. This reality arises from the growing globalization of the economies and the prevailing position of multinationals that under the joint pressure of markets and their shareholders seek to increase their profits without limits.

For such groups, taxes are a cost they seek to reduce[4].

A. ISSUES IDENTIFIED

Along with traditional issues relative to transfer pricing or tied to the transfers of financial or intangible assets, frequently discussed with multinationals, we increasingly witness “relocation” practices.

Effectively, such groups undertake internal reorganizations generally spurred by their participation in multiple market areas.

Thus, they justify corporate restructuring chiefly on commercial reasons, such as the wish to maximize synergies and economies of scale, optimize management of business lines and improve the efficacy of the industrial and commercial chain, taking advantage of the development of Internet-based technologies.

Contrary to industrial relocation sometimes experienced by France, as well as other countries, such relocation is marked by maintaining investments in our territories (plants, equipment, and offices) and staff.

Nevertheless, in general terms, such restructuring is marked by a redistribution of the income earned by the French entity, sometimes considerable.

Some of these relocations were performed among countries within the European Union to benefit from favorable regimes. But, after Member States adopted the Code of Conduct in 1997, which purpose is to put an end to such regimes within the Community, (see above), currently,

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[4] *For example, a report by Landwell in 2004 « Global retail and tax benchmarking survey» points out that the impact of a 1% reduction of the effective tax rate is identical with regards to the share price obtained with a 15% sales increase.*

countries with preferential tax regimes (for example, in Europe, Switzerland) benefit the most from the redistribution of the tax base. Presently, such relocation is performed by:

- The transformation of the corporations that fully perform distribution functions into distributors with limited risk or agents that conduct business on behalf of a related company;

- The transformation of manufacturers in sub-contractors or custom manufacturers that operate as agents of a related company.

  Such legal transformations pursue a significant taxable income reduction and generally translate into:

- Maintaining in France almost all the exploitation means (sites, equipment, personnel, etc.) and the business activity for custom manufacturers and agents and the transfer of senior management to the headquarters;

- Headquarters rendering services for all the related companies (accounting, payroll settlement, finances, HR, legal affairs, IT, etc.).

Overall, the headquarters become the service provider with regards to the custom manufacturer and the agent. It is responsible for the strategy, the purchase of raw material, the decision to commission production, and owns the finished products, stocks, and bears the risk with regards to prices, exchange rates and noncompliance by clients.

The operating subsidiaries, according to this structure, receive remuneration for the routine functions and reduce their profitability. They are deemed sub-contractors with low value added with a guaranteed but limited remuneration.

B. ACTION MEANS

The selection of the groups' form of corporate organization, mainly a legal decision adopted thereby, when evident, is not arguable from the tax standpoint, except when they pursue a tax purpose exclusively. According to the above, proving the legitimacy of the events, which would lead the Administration to make rectifications, is still difficult.

Consequently, our control services deeply examine the tax consequence of the restructuring schemes undertaken by such groups.

Firstly, they determine the effective nature of legal transformations. They verify that the economic risks and functions that were previously assumed by the corporation or the restructured French establishment are really transferred.

Should the restructuring correspond to the effective reorganization, the financial modalities shall be controlled. The Administration verifies that the prices applied in the framework of the new policy fit the principle of open competition after examining the functions performed, the risk incurred and the equipment and intangible assets used by each one of the companies in the group.

The extraordinary burdens tied to the restructuring (severance pay, losses from assets that lost their value…) may be dismissed when it is possible to prove they were incurred to the benefit of another entity in the group.

Should the restructuring not be effective, the agencies focus on an overall examination of the structure, considering the effective transfers among the subsidiaries, when applicable.

C. CONCLUSIONS

Our view is twofold:

- Such restructuring efforts are increasingly numerous and the transfer of profits arising therefrom are significant. Rectifications referred to restructuring operations account for approximately one billion Euros.

- The Administration's power to take action is limited before a complex problem, with imprecise legal frameworks.

Agencies face difficulties in establishing the burden of the proof in the transfer of benefits, obtaining the information required in doing so and the uncertainty with regards to the rule of law and the case law with regards to this issue, particularly in a Civil Law country where the contract is binding for the parties.

Other than the hypothesis of altering the facts, the consequences of reorganization may be argued pursuant to the normal transfer pricing principles, in order to determine the portion of income that shall be actually allocated to the restructured entity. This approach only barely corrects the effects of such relocation.

D. OUTLOOKS

1. International: Limiting the Attractive of Relocations.

In the international sphere, the relevance of the business restructuring phenomena leads the States to discuss this issue in the international fora.

a) At the OECD Level: Provide Guidelines.

The efforts of the OECD working group on «business restructuring», in which France participates, should be concluded in 2009.

The efforts are aimed at, on the one hand, developing a clear analytical framework that guarantees sufficient legal certainty for the «legitimate» restructuring of corporations vis-à-vis agreements as well as with regards to the transfer pricing notions, and, on the other, guarantee governments the possibility of countering abusive restructuring or those lacking an economic ground.

In practice, the idea is to identify to what extent the reallocation of income arising from a restructuring, in general, fit the principle of open competition and, more broadly, in what way may the principle of open competition be applied to restructurings.

Clear guidelines should be provided for the administrations as well as businesses with regards to the type and tax treatment for this type of transactions.

b) At the EU Level: Combat Harmful tax Practices and Continue with Harmonization Efforts.

At the European level, the work for the implementation of a common tax policy to prevent, at least, the relocations of an essential tax nature inside the EU are underway in the EU, and France participates actively therein.

Since by virtue of the Code of Conduct the Member States have promised to eliminate the tax measures that spur a harmful tax competition, to refrain from introducing more in the future (see above), the efforts by the group implemented in 1999 to identify and pursue the dismantling thereof, shall be continued.

France supports and also participates in the efforts on the Corporate Tax rate harmonization by adopting a common consolidated Corporate Tax rate to cover all the activities inside the EU of the corporations operating in several Member States (ACCIS or CCCTB, Common Consolidated Corporate Tax Base). Such efforts shall enable a more visible direct tax competency since it is based, essentially, only on the tax rates.

2. Internally: maintain the tax control pressure and prevent difficulties. Our policy consists in maintaining a strong pressure via tax controls to verify the tax relocations and adopt a stricter approach, inspired on the work underway in the OECD.

For example, it would entail verifying that a fair severance or compensation amount has been paid when the change in contractual relations results in a visible reduction of future income (loss of business opportunity).

But our action cannot be limited to an ex post control. In line with tax control, we have developed an active risk prevention policy at the beginning of the chain. In 1999, we implemented a procedure based on a pre-agreement vis-à-vis transfer pricing, a legal certainty instrument for corporations. By virtue of this procedure lead by an exclusive team within the Administration, it is enabled to examine such restructurings to the closest extent possible prior to their effectiveness. This procedure is an answer adapted to the difficulties identified, since it leads to dialog with corporations based on trust and transparency. It avoids the ex post policy for the Administration and enables to provide certainty for the groups in the implementation of the restructuring efforts. A total of 9 agreements were signed in 2006, 12 in 2007, and approximately 20 are expected in 2008.

III. THE INFORMAL ECONOMY

In France, concealing business activities is a form of avoiding not only the tax pressure, but also the social contributions and the administrative limitations of all kinds.

The harm caused by the informal economy – revenue and corporate tax losses that finance public policies and, mainly, social protection, false competition for qualified operators, laundering that favors criminal networks – justify that combating the informal economy be prioritized by the State, particularly, for the purpose of tax control.

The French model to combat the informal economy brings numerous actors and means to the forefront. This organization is firstly the result of an old political, economic and administrative history and the action of the State depends on our governing principles: equality, rule of law, tax equity, and assistance equity.

It is based on well-defined administrative structures, in a context of a high level of compliance, mainly with regards to taxes.

A. ISSUES IDENTIFIED

Beyond an individual's illegal or concealed activity, the non-filed activities, whether legal or illegal, assume different forms, with varying degrees of complexity:

- The use of companies who fail to file their statements, frequently short-lived intentionally and challenging the Administration's reaction capacity. This practice may be combined with the use of a cascade of sub-contractors, chiefly in the Public Works' sector;

- Conducting a relevant activity, breaking it down among a number of small corporations, enabling fraudsters to benefit from the advantages granted to the small businesses and transform important challenges into "apparently" weak challenges for the Administration and, therefore, ignored;

- A foreign corporation's permanent establishment undertaking an activity that they conceal (or fictitious relocations in a foreign jurisdiction).

We may also mention the activities, which have been filed, but whose actual volume is concealed by the reduction of the income produced by such activities. It is a simple, but broadly disseminated method.

Concealing a business activity is generally accompanied by illegal labor, that is to say, employment of employees who are not registered.

Although the informal economy may be pertinent to all activities, certain economic sectors are more involved, by virtue of their inherent features. We generally define three:

- The sectors that employ a large number of low-skilled workers, and in a high-demand period may be induced, based on the high contributions, to employ illegal workers: tourism, gastronomy, construction, agriculture, public works, cleaning services, textile industry, security services, etc.;

- Sectors whose activity generates circulation of cash, easy to disguise owing to their nature: retailers, bars, discos, hotels, restaurants, prepaid cards, etc.;

- Sectors that generate a strong value added, in which small volumes produce great income: IT, telephony, forgery and traffic of luxury goods.

To conclude, undertaking a concealed activity is currently facilitated by the evolution of the digital technologies that facilitate virtual transactions and offer communications' tools as well as, remote management, in absolute anonymity. They grant new outlooks to the informal economy with the effective support of the Internet.

Many sites enable to perform commercial activities, chiefly sales, which go uncontrolled by the use of pseudonyms. Such technologies allow the dissemination of certain procedures such as the use of off-shore accounts with credit cards linked thereto. To conclude, the use of accounting software or uncontrolled cash registers with functionalities that enable to correct transactions enables to easily conceal a part of the activity recorded initially.

B. ACTION MEANS

Although IT currently plays an important role in the management of useful administrative information, in France the struggle against the informal economy is chiefly waged on site, as close to the actors and the economic realities as possible.

Thus, we rely on resources devoted to investigation and intelligence, implementation of extraordinary procedures and coordination of the different pertinent State agencies to detect the concealed activities.

a) Exclusive Investigation Agencies.

We employ control and investigation units deployed as close as possible to the activity center (more than 1000 agents), which guarantee the liaison with other Administrations.

At the national level, a National Tax Investigations' Directorate (over 400 agents) is in charge of identifying the most complex fraudulent behaviors and controlling the high risk activities in the situations requiring a great response capacity. It cooperates with other equivalent EU agencies.

b) Extraordinary Administrative Procedures.

In addition to numerous mechanisms facilitating access to third-party information, the Tax Administration relies on two procedures adapted to the detection of concealed activities:

- The right to conduct on-site inspections and attach assets, an exceptional administrative procedure, prior a court authorization, in professional and private locations and attach accounting or non-accounting documentation in order to establish the alleged fraud, to subsequently face the taxpayer therewith. It is a passive search;

- The immediate tax authority to facilitate the enforcement of preventive attachments upon proving fraudulent practices of confirmed severity such as a concealed activity or employment of illegal labor. This is a means to secure collection of the taxes avoided.

c) Inter-Ministry Action Centered on Illegal Labor, the Common Denominator in the Phenomenon.

Violations related with the informal economy depend on several laws and administrations (tax, social, labor, customs, economic, etc.). Circulation of information and common efforts need to be organized among the different agencies.

Such coordination and its exchange focused on illegal labor or illegal activities shall be performed at:

- The anti-illegal labor Operating Committees, which bring together, at the level of Departments, the control bodies of the different administrations (labor, social, taxes, law enforcement, etc.) under

the authority of the District Attorney. It is the key structure of the operating anti-illegal labor effort. Such committees organize the circulation of information and guarantee on site coordination of the actions. In practice, monthly meetings are organized in which participants exchange information on fraudulent activities or networks, each Administration presents the issues addressed and, subsequently, joint actions are decided and organized. Such meetings are coordinated by the administrations, either individually or collectively;

- The Immediate Intervention Groups (*Groupements d'intervention rapide, GIR,* as per the French acronym): inter-ministry operating structures created in 2002, whose mission is to counter the informal economy and the different forms of organized crime (drug trafficking, stolen objects, etc.). The GIR bring together the agents deployed to such purpose (agents from law enforcement agencies, border patrol, customs, tax authorities, fraud control, labor) who report to a police commissioner or border patrol officer.

In addition to these two mechanisms, our investigation services work more actively and bilaterally with other State agencies.

C. CONCLUSIONS

The results of tax control efforts in terms of detection, related control and punishment, except for collection, which remains low, are high (2007: 8,300 inspections revealing income or activities concealed for a total of € 450 Million worth of evaded taxes, 800 tax fraud cases in court).

Nevertheless, such results do not allow, per se, measuring the effects of the actions of the Administration on the informal economy.

They should even call to caution, since they prove that, if sustained at high levels, the struggle against the informal economy – a tax control priority for a number of years–is not exhausted and the phenomenon prevails.

On the other hand, the general perception is broadly that the informal economy remains important and that the new related methods, mainly the Internet, enable its further expansion.

- The assessments of this parallel economy are diverging. The methods are complex and frequently weak. Recent studies estimate tax and social contributions' evasion between 30 and 40 Billion Euros from illegal labor and informal economy, which would account for 3 % of the GDP.

On the other hand, we may observe that society tolerates the informal economy and fails to perceive its severity.
Finally, this phenomenon is not appropriately addressed by the State, whose agencies still fail to integrate.

D. OUTLOOKS

In the face of this context, our action is aimed at improving citizens' awareness on the severity of this phenomenon, better coordinate State agencies and furnish them with the most effective tools.

d) Communicate on the Consequences of Tax Fraud.

Just as in the case of tax havens, we are considering an important tax fraud communications' campaign to inform the population, mainly the higher-risk groups, on the effects and risks of tax fraud.

e) Continue the Integration Policy with State Agencies that Sometimes Act Dispersedly Against the Informal Economy.

We have decidedly implemented a policy to integrate the administrations and improve the cross-sectional action by all the actors involved in the combat against crime.

On April 3rd of 2008, the tax and social administrations have entered into an agreement aimed at organizing, facilitating and following-up information exchange efforts. The databases of different administrations shall be crossed.

The agents from both entities shall assume reciprocal obligations in terms of fraud identification and information delivery.

Training and information programs shall be implemented to explain to each agent involved the individual area of competencies and improve the global knowledge of fraud phenomena.

This agreement reflects a strong will aimed at fostering relations among the agents involved that shall apply locally within the framework of the agreements subscribed by the agencies.

On April 18th, we also created a National Anti-Tax Fraud Delegation. The Delegation, created by decision of the Prime Minister, under the responsibility of the Ministry of Budget, has the Mission to:

- Protect the efficacy and coordination of the anti-tax fraud actions performed by the State and Social Security agencies;

- Improve the knowledge on fraud with an impact on public finances;

- Favor the development of information exchange efforts and the interconnection of the databases of the different administrations involved in tax fraud issues.

f) Improve the Administration's Capacity to Detect the Concealed Operators.

Two measures:

- Obtain the information on the anonymous Internet users for commercial purposes. In order to identify and locate the users of the e-commerce sites, including free ones financed with advertising, the Administration shall access the data identifying them kept by the Internet Service Providers, by hosting companies and e-commerce service providers.

- Evidently, the tax police mentioned in the framework of tax havens could offer new tools to detect and mislead the operators of the informal economy.

IV. CONCLUSIONS

Beyond these three critical issues and the answers triggered by each one, our approach to increase tax compliance in France is based on a permanent balance among our two action axes:

- Ongoing improvement in the quality of taxpayers' services, chiefly, by simplifying the formalities required, improving our organization,

making it user-centered to favor their access, broad guarantees based on relations of trust, as well as a strong legal certainty. Overall, the Administration should facilitate taxation;

- And a structured tax control, with an ongoing intensity, present in a balanced fashion in all the sectors and across the territory, focused on their budgetary, deterrence and punitive purposes. In fact, we work on the basis of the principle that in the current context, favorable to tax fraud, the progress made to facilitate taxation does not justify a reduction of tax controls.

Case study

Topic 2.1

EMERGING RISKS IN AGGRESSIVE TAX PLANNING

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CONTENTS: Summary.- 1. Tax issues emerging from a globalized economy.- 1.1 Shifting the tax base of businesses and their economic activities.- 1.2. Harmful tax planning.- 1.3 The issue of double taxation.- 2. Measures adopted against international tax planning schemes.- 2.1. Legal measures.- 2.2. Ancillary administrative measures required for tax planning control.- 2.2.1. Special monitoring of large taxpayers.- 2.2.2. The public digital record system.- 3. Risk management.- 4. Case studies.- 5. Conclusions and recommendations

SUMMARY

This brief study deals on the emerging risks of international tax planning, focusing on the Brazilian experience. The free movement of production factors, the key feature of the phenomenon of economic globalization, modified the strategies of large businesses. In their business expansion, economic groups started to make direct investments in other countries, disrupting the production and distribution chain for their products or services, in agreement with the costs and expenses from their income taxes. This new international economic scenario served as fertile ground for tax planning schemes. The issues arising relate to the shifting of the tax base from one location to the other, with lower tax pressure, with harmful tax competition and with the double taxation phenomenon. In order to counter and neutralize the effects of aggressive planning, thus avoiding revenue losses, control measures are adopted in the legal and administrative fields. In general terms, these schemes are dismantled by applying the principle of substance over form by means of legal actions and businesses conducted to overcome the incidence of the tax regulation. In Brazil, a Civil Law country, this principle applies on tax matters by the enforcement of anti-fraud legislation. Among the administrative measures adopted by the Brazilian Administration in controlling international operations, we

may highlight the following: **i)** special control of large taxpayers and **ii)** the Public General Record System (Sped, as per the Portuguese acronym). This paper concludes with a reference to the aspects of the management and risk assessment system geared at international tax planning. For such cases, the methodology based on the study of specific situations, the bottom-up approach, is used as the basis to plan new audits. As examples, we also present and comment on two case studies that the Tax Administration deems successful. In Brazil, reality has shown that the effectiveness of anti-tax avoidance measures is tied to the availability of evidence overall. In both cases, audits succeeded in proving the abusive (illegal) purpose of the tax planning instruments and mechanisms, with an inordinate amount of effort that exceeded the scope of scheme.

INTRODUCTION

In recent years, with the opening-up of the economies, the challenges facing tax administrations with regards to tax planning schemes are no longer limited to the domestic sphere. With the phenomenon of globalization, the economic borders among countries became blurred and the volume and modalities of international transactions grew. With technological progress, especially as regards communications, the mobility of capital appears as the main feature of economic globalization. This new economic scenario, marked by increasing mobility of the production factors, favors international tax planning schemes to a great extent.

This liberalization in the movement of financial resources enabled businesses to adopt new growth and expansion strategies for their activities. Economic groups started to disseminate their activities in different countries, based on the lower cost of production in each stage and the lower tax burden on their income. Consequently, this freedom to organize their business activities enabled the emergence of aggressive tax planning schemes, by which companies seek to lower their tax burdens by using mechanisms and schemes contrary to the countries' tax legislation.

In order to counter and neutralize such schemes, countries have adopted legal and administrative anti-tax avoidance measures. Unlike the case of anti-tax evasion regulations, the purpose of anti-tax avoidance measures is to eliminate the legal vacuums that enable the abusive reduction of the tax base or its displacement towards another country with more advantageous taxes.

This new context has forced tax administrations to adopt more dynamic and stricter approaches to control schemes and the players involved in tax planning. The development of a risk management and risk assessment methodology vis-à-vis aggressive tax planning, which exploits the exchange of information and experiences among countries, became vital. The implementation of such system aims at achieving more effective action by tax authorities, with a more appropriate and timely allocation of typically scarce resources.

The purpose of this brief study is to consolidate the most relevant aspects in treating international tax planning cases as per the Brazilian experience. We shall analyze the circumstances underlying such schemes, such as the mechanisms that facilitate the shifting of the tax base, harmful tax competition, and double taxation. We shall also present certain control measures, in both the legal and administrative spheres.

Discussions regarding emerging international tax planning risks become relevant for the tax administrations to the extent the new economic scenario affects all countries indistinctly. Currently, the tax administrations are forced to improve their methods, eliminating legal vacuums and streamlining their use of resources in the national revenue collection function. The delay in pursuing appropriate solutions to counter the different international tax planning schemes derives in greater difficulty in recovering tax credits, whose magnitude requires current tax administrations to include this item on their agendas.

1. TAX ISSUES EMERGING FROM A GLOBALIZED ECONOMY

The opening up of the economy and the mobility of the capitals spur relevant tax issues. Countries are now faced not only with their national taxpayers, but also with citizens who reside in other countries but conduct their business, and obtain income, in the territory of the former. Likewise, national taxpayers started to produce income in other countries and to subject themselves to the legislation of other jurisdictions. From this complex scenario of international relations emerge countless tax conflicts. The causes of such issues are, on the one hand, the general growth of direct investment by transnational companies, and, on the other, maintaining national tax sovereignties and their tax structures, conceived prior to globalization.

Therefore, the simultaneous enforcement of taxes by the country where the income is produced and the country of taxpayers' residence

underlies the relevant issues currently facing the tax administrations. In order to neutralize the tax effects deemed harmful for the economic activity, and in view of the need to remain competitive in the world market, economic agents seek to reduce production costs, and consequently, the tax burden.

Modern business strategy almost imposes upon economic agents the need for pursuing more favorable tax systems to conduct their activities. International tax planning is structured according to this objective to ensure an effective reduction of the global tax burden, according to the regulations of the legislation in force in the different countries in which they operate. From this perspective, setting up economic activities in different countries with the purpose of reducing costs, including the tax cost, does not necessarily entail illegal or irregular behavior. This is known as legal tax planning or tax avoidance.

Nevertheless, in addition to the purely legal tax planning practices, there is another questionable behavior, which is closer to illegality, namely that whereby the taxpayer uses legal actions or businesses to achieve tax savings by skillfully and cunningly dodging the incidence of the tax norm. This is deemed abusive [1] (or elusive) planning, for despite being shaped in the form of legal actions or businesses, it lacks a legitimate purpose; it is simulated or practiced illegally by abusing the law and exclusively aimed at avoiding the incidence of the tax norm.

At the core of this tax issue are circumstances that underlie the majority of the planning schemes and shall be highlighted in this brief study. The analysis of risk indices linked to the operations structured by transnational companies for purposes of reducing tax expenditures reveals that tax planning is based on:

a) Shifting the tax base and the economic activities towards lower taxation areas;
b) Harmful tax competition, implemented by tax havens; and
c) Double taxation.

In the experience of the Brazilian Tax Administration, the schemes and instruments found in international tax planning relate to at least one of these three aspects. Such circumstances favor the structuring and use by transnational corporations of aggressive tax planning schemes,

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[1] *Hereinafter, we shall use the expression "international tax planning" to designate this abusive form of business organization with the exclusive purpose of reducing tax expenditures.*

with the only purpose of reducing the tax incidence on their activities. The challenge lies in establishing methods for the effective control of the transactions subject to taxation in the country, considering the connection with the foreign jurisdiction, which invariably makes this issue more complex.

1.1. Shifting The Tax Base of Businesses and Their Economic Activities

The issue of shifting the taxable income and the economic activities affect taxation of corporations as well as individuals. In the case of corporations, there are two relevant situations: when companies base their productive activities, either totally or partially, in a given country based on the tax affecting a given activity or stage in the productive process; and when companies resort to the transfer pricing mechanism to shift the taxable income to foreign jurisdictions to benefit from more favorable taxation.

As regards individuals, the issue is tied to the high degree of mobility of highly skilled labor, for example, artists and sports stars. Large taxpayers move to low taxation jurisdictions, promoting a reduction in the system's progressivity, which impacts the smaller incomes, levying workers with lower mobility.

We have found that shifting the tax base towards jurisdictions with lower tax pressure has become increasingly easier. Nevertheless, even in the face of lax regulations, corporations go one step further and use aggressive tax planning to make their suspicious actions and businesses appear legal. The currency exchange tools facilitating the movement of capital frequently end by diverting their purpose and are employed as means to "shield" income and equity from Tax Administration scrutiny.

1.2. Harmful tax Planning

Two different situations characterize harmful tax competition. The first one is the proliferation of tax havens. The second are preferential tax regimes, such as the regimes for specialized businesses, off-shore jurisdictions and financial jurisdictions. Such systems present certain common features, such as reduced tax rates and tax advantages for certain activities performed by non-residents. Additionally, tax havens as well preferential tax regimes keep strict commercial, banking and tax secrecy regulations and restricted information exchange rules.

Such situations may spur harmful tax competition to the detriment of the countries that do not implement similar measures and are forced to institute stricter controls to avoid the progressive loss of revenue. Tax havens and preferential tax regimes lack the transparency required for tax administrations' action, thus becoming highly attractive territories to channel suspicious transactions aimed exclusively at reducing the tax burden.

In Brazil, the international tax planning schemes detected almost always refer to a corporation chartered in such jurisdictions. The resulting challenges are related with the impossibility of obtaining information, the existence of agreements, and internal laws that impose absolute confidentiality on the transactions conducted in such jurisdictions.

1.3. The Issue of Double Taxation

Double taxation, understood as the enforcement by two different States of a similar tax on the same taxpayer and the same income, occurs upon the overlapping of a tax sovereignty that adopts the principle of territoriality (taxation in the source Country) and another one that adopts the principle of worldwide income (taxation in the Country of residence). Simultaneous enforcement of these criteria by two different jurisdictions creates double taxation, which may render the economic activity economically unfeasible by virtue of the excessive tax burden. With the free-flow of capital, double taxation became recurrent both in developed and developing countries. The increasing intensity of the flow of capital among countries, materialized by the expansion of businesses by means of direct investments in other countries, lies at the heart of double taxation-related issues.

This conflicting and threatening situation for the economic activity has led the different States to establish, by means of unilateral and bilateral measures (international agreements), mechanisms to avoid, or at least mitigate, the effects of double taxation.

Among these mechanisms, we shall highlight exemptions, the possibility of tax credits, deductions from the calculation base and the enforcement of more favorable tax rates. Overall, the tax systems started to offer taxpayers who could potentially be affected by the phenomenon of double taxation a series of tax benefits and advantages.

This legal-tax structure constitutes fertile ground for the emergence of countless plans and devices to obtain tax advantages and savings,

either legally or illegally. We may determine that some of the schemes employed in international tax planning arise from artificial maneuvers to enjoy the benefits and advantages provided by taxation agreements designed by the different States with the purpose of avoiding or reducing the effects of double taxation.

2. MEASURES ADOPTED AGAINST INTERNATIONAL TAX PLANNING SCHEMES

Just like other countries, Brazil adopted different legal and administrative measures with the purpose of eliminating vacuums and hindering the efforts of the companies that resort aggressive tax planning as a form of reducing their tax payments.

2.1. Legal Measures

According to the specificities of each legal system, countries have been countering international tax planning schemes by enforcing the so-called principle of substance over form. According to this legal principle, the facts shall be assessed under the scope of their economic and commercial reality, based on good faith, rather than their apparent formal content.[2].

Based on the civil law system, Brazilian legislation adopted the simulation[3] regulations in order to guarantee the principle of substance over form. The entity of simulation, enshrined in the Civil Code, constitutes the only limit traditionally acknowledged to avoid transactions aimed at tax avoidance.

Simulation is characterized by an imbalance between the explicit will and the implicit will. According to most theories and case law, simulation only occurs when the existence of two different wills is determined.

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[2] *Norms of this nature enable tax authorities to examine the transaction performed by the tax-payer according to the form of business organization in order to establish the fundamental economic reality of the business. This theory also considers the artificial transactions performed with an apparent business purpose, but are exclusively motivated by a reduction of the tax burden.*

[3] *Simulation emerges when the apparent transaction differs from the actual transaction and is not grounded on reality or the actual or effective intention of the parties. Tax authorities may ignore the simulated transaction and consider it effective when: i) the actions seem to grant or convey rights to individuals other than those to whom the rights are actually transferred or conveyed; ii) when it contains a false statement, confession, condition or clause; and iii) when the specific instruments bear a previous or subsequent date. Therefore, when none of the simulation assumptions are verified, the valid act is suitable for tax purposes.*

Nevertheless, this extremely orthodox entity is being mitigated by the influence of certain authors, who assert that simulation not only applies to the will expressed by the parties, but also to the business purpose[4]. In the sphere of the Tax Administration, the assessment of the effectiveness of this measure in countering international tax planning schemes indicates its relevance, since it applies to different situations in which the actions and businesses, in spite of being illegal, are undertaken with the sole purpose of avoiding the tax legislation.

Nevertheless, the employment of the legal entity of simulation requires an in-depth investigation and the careful production of evidence. Its use as a measure to neutralize the tax planning schemes depends of its entire applicability as a private law rule. Since it is general in nature, not specifically concerning Tax Law, the enforcement scope is broad. Even so, it requires a double effort by auditors in the investigation phase, which shall present sufficient elements to prove the abusive tax planning and that it was conceived with no purpose other than taxation and, therefore, the actions and businesses simulated shall be deemed null for tax purposes.

Other legal measures have proven effective in our legal system. Among them, we may mention the norms that introduced taxation based on the principle of worldwide income and those geared at transfer pricing control. The measures that also contribute to counter international tax planning schemes are those setting forth special rules for the transactions conducted with low taxation countries or regimes. Brazilian legislation considers that a low taxation country is the country that exempts income or applies a tax rate lower than 20% (twenty per cent), or whose domestic legislation defines relative confidentiality regarding the corporate structure or ownership of corporations.

Recently, this notion has been expanded. The transactions performed with companies under preferential tax regimes were subject to the same

[4] *According to these scholars, in order to know if the business is simulated, it is necessary to verify whether there is consistency among its origin and the nature of the business per se. From this outlook, we may assert that the business is simulated when the business purpose is non-existent, or is incompatible with the core business adopted or when there is a mismatch between the actual purpose and the apparent purpose. For example, an investigation is warranted in the following assumptions: If the business purpose was to sell the industrial facility, why was a spin-off pursued? The ground for a spin-off is not the same legal ground of a sale, since the legal ground of the spin-off is to break down the company into different ventures, for each one to optimize the use of resources.*

transfer pricing control rules. Pursuant to the new law, a preferential tax regime is one which:

a) applies zero taxation or a maximum tax rate lower than 20% (twenty per cent);
b) grants tax advantages to the non-resident individual or corporation;
   I. Without requiring the core economic activity to be performed in the country or venue;
   II. Subject to the non-performance of the core economic activity in the country or venue;
c) applies zero taxation, or a maximum tax rate lower than 20% (twenty percent) on the foreign income earned; and
d) does not enable access to information relative to the corporate structure, equity ownership or entitlements or the economic transactions performed.

Even regarding the measures tied to the transactions that consider the preferential tax regimes, we should mention the differentiated treatment of the income earned by their residents in the Country. Profits, capital gains and other benefits paid, credited, delivered or remitted by a source located in the Country to an individual or corporation resident or domiciled in tax havens, are commonly subject to the incidence of the source income tax at a higher tax rate of 25% (twenty-five percent).

Practice has proven that the effectiveness in the enforcement of anti-tax avoidance measures is attained with a careful investigation proceeding. This always demands complex tax auditing efforts, with a knowledge and skill that requires training employees in dealing with transnational corporations.

2.2. Ancillary Administrative Measures Required for Tax Planning Control

In the administrative sphere, the Brazilian Revenue Secretariat has implemented ancillary measures that contribute to expand voluntary compliance and increase the risk of adopting irregular behaviors to reduce the tax burden. One of the objectives of these measures is to control the transactions involving known risk indices more closely and timely.

Among the mechanisms implemented in the administrative sphere, we may highlight the special monitoring of large taxpayers and the institution of the Public Digital Record System.

2.2.1. Special Monitoring of Large Taxpayers

Special monitoring consists in regularly reviewing the collection levels in terms of the economic-taxation potential of corporations and the relevant macroeconomic variables. In this process, administrations use both data available internally and information gathered from external sources.

In the local units, the team responsible of such task shall identify relevant distortions, analyze and record on the monitoring systems the justifications, recommendations, provisions and results achieved with the actions adopted and, if necessary, propose concrete actions with regards to the events underlying the distortions detected.

These actions are governed by a holistic view of the taxpayer. The analysis includes taxpayer's overall tax affairs. In addition to revenue monitoring, the requests for tax set offs and refunds are verified, as well as the legal actions against the Administration and the most recent financial statements. The aim is to create a tighter bond with the different taxpayer aspects, complete and timely, considering the most relevant transactions thereof.

2.2.2. The Public Digital Record System

The Public Digital Record System (Sped, as per the Portuguese acronym) was conceived with the purpose of promoting the integrated action of the federal, provincial and municipal administrations by standardizing and rationalizing the information and shared access to the digital taxpayers' record. The System shall enable to simplify the current ancillary obligations, with the subsequent reduction of the administrative costs for businesses. The measure shall be also based on the need of eliminating the repeated delivery of tax information to the different administrations.

Additionally, with the digital record, businesses shall reduce issuance and storage costs of paper documents. The accounting and tax documents stored on digital media shall enable to improve the internal invoicing and operational logistics processes. From the standpoint of the Tax Administration, the Sped shall enable an improvement in the quality of the information aimed at controlling tax evasion and avoidance.

Among other electronic documents to be prepared and stored on digital media, the Sped includes:

a) the Digital Accounting Record (ECD, as per the Portuguese acronym) – Journal and Accounting Books, Daily Balance Sheets and Balance Sheet, Journal and Auxiliary Book.
b) the Digital Tax Record (EFD, as per the Portuguese acronym) – Input and Outputs' Record, Records of Accounting of Taxes on Assets and Services and Inventory Records;
c) the Electronic Invoice (NF-e, as per the Portuguese acronym);
d) the Electronic Transportation Bill (CT-e, as per the Portuguese acronym) – similar to the NF-e, shall cover all the transportation modalities (road, railway, aircraft, river and ducts);
e) the Electronic Services Invoice (NFS-e, as per the Portuguese acronym);

By the force of the sub-legal administrative regulations, the digital record is mandatory for the almost 10 thousand taxpayers under the special control system, mentioned under item 3.2.1. With regards to the accounting events occurred as from January 1st of 2008, such taxpayers shall carry a digital accounting record, pursuant to the specifications of the Sped. As of January 1st of 2009, the obligation shall be extended to include close to 145,000 businesses in the system.

The Sped initiative constitutes an innovative leap in tax control. The complete information on taxpayers' transactions shall be available for analysis almost in real time with respect to the events. For the Tax Administration, the system shall contribute in the timely identification of the risk indices, enabling the immediate action, broadening the success possibilities, mostly based on the facilitation to determine aggressive planning schemes.

Special monitoring of large taxpayers as well as the Digital Record System constitutes an important initiative because they create new control mechanisms, less costly for the Tax Administration and for businesses. The current challenge for the Administration is to proceed on a timely and strict basis to secure the success of the tax policy and the collection levels. The current scenario requires the Tax Administrations to perfect their methods and techniques on an ongoing basis, and this calls for the modernization of their instruments and the evolution of the information systems.

3. RISK MANAGEMENT

The Tax Administration must develop a reliable methodology to assess the risks posed by the different international tax planning schemes. Risk management is a "subtle and complex art" of analyzing taxpayers' profile in the face of the different potential risks of the economic activity performed thereby. Nevertheless, there is no perfect methodology that successfully applies to all the tax administrations. Risk management shall consider the context in which the Administration performs the specific reality of each country.

In Brazil, the international tax planning case studies revealed that the risk profile of a given taxpayer shall consider the following indices, among others:

a) the overall taxes actually included;
b) the size, structure and complexity of the business and its forms of financing;
c) domestic tax control (strategy to reduce tax expenditures);
d) the trend of construing the law differently from the Tax Administration, even resorting to the Courts to claim Precautionary Measures;
e) the special interest for tax planning schemes;
f) the degree of reliability of the IT systems and processes;
g) the legal complexity of business;
h) the degree of openness and transparency of their transactions; and
i) the cooperation background with tax authorities.

The Brazilian experience has proven that the quality of the sources of information is relevant in tax planning risk assessment. In general terms, the primary source of information on taxpayer activity is the tax statement. Such information is normally supplemented with the one obtained from other sources, even third-parties. In this regard, the expansion of information exchange efforts and experiences in countering such schemes becomes relevant. The Standing Committee for the Control of International Tax Planning, created under the CIAT umbrella, intends precisely to reach such objective in 2008.

In the cases of international tax planning, tax statements are limited when employed as primary sources of information for the identification of risk indices. The information filed by the taxpayers involved in tax planning schemes is normally consistent and in line with the

information filed by the other taxpayers in the same segment. The exclusive analysis of tax statements does not suffice to identify the tax irregularities tied to tax avoidance, being mostly used to identify tax evasion practices.

The cases of international tax planning have been identified by the detailed analysis of transactions, according to the methodology based on paradigmatic cases, the bottom-up approach. This analysis is based on fundamentals and starts with the objective assessment of the known risk indices. Upon concluding the audit on the taxpayer selected as the paradigm, the case is studied again by an in-depth examination of the legal, tax and procedural aspects. In this study, other indices are identified for this given planning scheme and the system receives feedback. After consolidating the knowledge on the scheme, new audits are planned, with a view to obtaining the best results with the available resources.

Considering the peculiarities of the Brazilian Administration, this working methodology has proven fruitful for the cases of tax planning and has enabled an appropriate resource allocation.

4. CASE STUDIES

In Brazil, the Tax Administration identified tax planning schemes involving transactions with foreign individuals and corporations. Among the most recurring mechanisms employed by taxpayers to avoid the incidence of the tax legislation we may state the following:

a) shifting the tax base by abusive manipulation of the prices established among related parties;
b) simulated commercial transactions among Brazilian companies and off-shore companies chartered in countries with preferential tax regimes; and
c) the fraudulent set up and restructuring of corporations with the sole purpose of avoiding the incidence of taxes.

Considering the objectives of this document, we shall address two specific cases, with favorable outcomes for the Administration. In both examples, the broad and qualified investigation phase gathered elements that identified the form of the actions and business undertaken. This enabled to apply the tax legislation on the substance of the events, in spite of taxpayers' attempt to conceal them.

Arbitrators admitted the tax auditor's opinion that disqualified the formal legal acts on the ground of being void of any motivation other than tax fraud, and accepted the theory underlying the generating tax event, which taxpayers, by resorting to tax planning, tried to avoid cunningly.

4.1.1. Case Study 1: Corporate Restructuring by Swapping Equity Shares

In this first case, the audit determined the adjustment of the Income Tax base of corporation KP (a holding company) to include the income from capital gains, calculated based on the disposal of investments assessed with the Net Worth Method[5].

Shareholders S1 and S2 own all the shares in corporation MBB, whose activity is the publication and trade of books. In order to perpetrate the abusive corporate restructuring, both decide to charter corporation KP, by integrating the shares they owned in corporation MBB. Subsidiary KP, a holding company, changed the corporate name of company MBB to SEB and, at the same time, decided its spin-off, which originated MB. SEB (formerly MBB) remained as the original corporation, keeping the respective assets and liabilities and real estate property. MB, created from the spin-off from SEB, received the operating assets of the original company.

On the other hand, the shareholders of corporation PEB also chartered a controlling company by the name of PEP. PEP (a holding company), in turn, created corporation MIP.

Shareholders S1 and S2 signed an agreement within PEP, undertaking to transfer the total shares of corporation MB (arising from the spin-off) and, on the other hand, PEP committed to transfer by swapping the total shares of MIP. In that transaction, KP transferred its MP shares and received the shares from MIP in exchange, and PEP transferred all the shares in MIP and received in exchange the shares of MB. In other words, the owners and shareholders swapped the shares of their controlled corporations so that PEP became the only shareholder in MB, and KP, the only shareholder of MIP.

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[5] *According to the Net Worth Method, companies must assess the investment in related companies according to the net worth variation of the beneficiary company. In each base Income Tax calculation period, the positive or negative income of the beneficiary company is not considered in the income of the investing company. According to this method, income tax is deferred until the disposal of the investment by the investing company.*

The case is that, at the time of the swap among the corporations, MB shares were worth $4,312 and MIP shares $18,972, both assessed according to the net worth equivalence. KP assessed its share in corporation MIP according to the net worth method, reporting assets for $18,972. On the other hand, it reduced its shares in MB for a $4,312 amount and listed the $14,660 difference as non-taxable income of net worth equivalence.

The tax audit determined a $14.660 taxable income applicable in the transaction performed by KP. It decided that the transaction performed under an apparent share swap among holding companies was, in fact, a sale, concealed by the parties.

The argument was based, firstly, on the lack of non-tax grounds for such transaction. MIP was created for the purpose of the swap and the only reason was to reduce taxes. The Income Tax Law sets forth that a capital gain shall be recorded upon the disposal of the investment in a controlled company. In this case, should KP proceed with the sale transaction, it would receive $18,972 from PEP for its equity ownership, which would imply acknowledging a $14,660 taxable equity. Nevertheless, KP pursued the swap transaction, transferring the asset assigned at its net worth value and receiving the new asset at its net worth value as well.

Should MIP have been an existing company, in business already, with income-producing operating assets for their owners, the swap would have been a perfectly normal operation. Nevertheless, MIP failed to conduct business prior to its sale, since it did not exist. The audit determined that the company was limited to a current account with a given financial institution.

The features of the simulation were the second reason to prosecute corporation KP. In agreement with the Brazilian legal system, simulation applies when there is a divergence between the implicit and explicit will, when there is consensus between the parties and the intent of harming third-parties that do not belong to the business.

The effective non-existence of MIP indicates the divergence between the explicit will (swapping shares) and the implicit will (acquiring shares in MB, since the corporation to be swapped was actually non-existent). The form in which the companies in the group and the partners used MIP resources indicates that the acts were simulated and pursued with the purpose of avoiding the taxation applicable in the transfer of the

investment. The audit concluded that by avoiding taxation of capital gains, by recording the net worth equivalence as income, this tax planning scheme produced losses to the Administration for a $4,976 amount approximately.

4.1.2. Case 2: Re-invoicing in Companies Chartered in Tax Havens.

In this second specific case, the tax audit determined the adjustment of the Income Tax for company MPO, to include the income omitted by the re-invoicing practices involving corporations chartered in low taxation jurisdictions.

Brazilian corporation MPO produces and exports industrial machinery. Its exports are performed via two related foreign companies. The audit work started with a formal report by the customs authority of the unit from where the machines would leave Brazilian territory. The customs unit detected a divergence in values from the documents filed with the national customs authority and those filed with the foreign customs authority.

As regards audit planning, the possibility of enforcing transfer pricing control rules was disregarded. The preliminary analysis showed that MPO applied prices that were in line with Brazilian legislation and, accordingly, the audit would fail to find enough grounds. Nevertheless, the procedure was initiated to verify the legitimacy of MPO transactions in-depth, considering the use of companies chartered in tax-advantage jurisdictions as a relevant risk index.

The audit investigated that corporations MPB and MPU, both chartered in a foreign jurisdiction, were employed as formal intermediaries in business transactions, which, essentially, corresponded to direct transactions between MPO and its end clients (importers) in foreign countries. MPO would sell the products directly to the end buyer and would arrange the price therewith, as well as the remaining business conditions. Nevertheless, the transaction required two invoices: one issued by MPO and aimed at one of their controlled foreign companies (MPB and MPU) and another one issued by such controlled companies to the end buyer and with a higher average value ranging between 14% and 19%. Nevertheless, both invoices were issued by MPO in Brazil and signed by the same employee.

MPO adopted the scheme of the re-invoicing centers for the purpose of tax planning, which consists in chartering companies in zero or low taxation jurisdictions. The only purpose is to re-invoice commercial transactions with the resulting reduction of the tax base in the country of origin.

Such affiliates are normally chartered formally, but inexistent in practice. In most cases, they lack permanent staff or keep a reduced number of employees and the goods exported are always shipped directly to the end buyers. This strategy is aimed at transferring the overall income in whole or in part towards jurisdictions with lower tax pressure that, additionally, apply secrecy on the transactions performed.

The adjustment conducted by the tax audit was based on the noncompliance with the income record, marked by the under-invoicing in the Country of the sales performed via the foreign corporations. The adjustment amount was calculated based on the positive difference between the price re-invoiced by corporations MPB and MPU and the amount of the invoice issued in the Country by MPO. The difference between those two values was considered an omitted operating income, excluded from the MPO accounting records.

i) The investigation phase was based on the leads that questioned the effective existence of foreign controlled corporations, in spite of being formally chartered. Among the numerous elements of the evidence gathered, we may highlight:

a) The summons to prove the effective existence of their foreign affiliates. The company presented telephone and electricity bills that determined the inexistence of any activity in such jurisdictions. MPO failed to prove the effective existence of the foreign controlled corporations, in spite of the services contract in place that set forth the responsibility of the affiliates in the official distribution (purchase, sale, sale promotion and post-sale service), as regards agents (sales' management), in addition to keeping furnished offices, skilled staff, etc;
b) The technical assistance service for product buyers, which MPB and MPU agree to provide either directly or by outsourced third-parties, is effectively provided by MPO itself;
c) The lack of sales' contracts between MPB and MPU with end buyers; and

d) The overall documentation and invoices from MPB as well as MPU were issued at the premises of MPO in Brazil, signed by its employees, who did not receive any remuneration from the foreign companies.

The audit concluded that MPO established an abusive tax planning scheme. The scheme ignored the Brazilian legislation that governs tax relations from business transactions among related companies (transfer pricing and taxation based on worldwide income). MPO resorted to the transfer pricing rules as a component of simulation, giving operations the appearance of legality. Likewise, legislation on worldwide income was also cunningly ignored by MPO, which resorted to jurisdictions that traditionally lack transparency.

The arbitrators accepted the theory of the tax audit. In the face of the events presented, the administrative sphere considered that the adjustment made based on the simulation of transactions is admissible.

4.1.3. Anti-Tax Avoidance Measures Applied in Cases 1 and 2

According to the foregoing, Brazil is a Civil Law country, and the mechanism applied to dismiss the actions and businesses created for the sole purpose of avoiding the incidence of taxes is the simulation[6] regulation. This legal entity allows the prevalence of substance over form in the actions and business performed with the purpose of avoiding the tax legislation. It is a Civil Law regulation that belongs to a branch of law different from tax law and is interconnected only systematically, just like the different branches of law. Its application in the international tax planning cases requires an additional auditing effort. In the cases presented herein, the work to gather sufficient evidence to show, by means of leads, that the actions and businesses performed concealed relevant facts for the incidence of the tax regulation deserves to be highlighted.

[6] *Simulation has been provided for in the Brazilian Civil Code (Act N° 10.406, of January 10th, 2002) under Article 167, which sets forth: "Art. 167. The simulated business is null, but what was concealed shall persist, if valid in substance and form. § 1° Business simulation shall occur when: I – entitlements are apparently granted or transferred to individuals other than the actual beneficiaries; II – a false statement, confession, condition or clause is contained; III – the specific instruments feature a previous or subsequent date. § 2° The rights of bona fide third-parties are waived before the parties to the simulated business."*

In both cases, the adjustments were legally supported by the provisions in the National Tax Code, in Article 149[7], which establishes that the proceeding is conducted and reviewed officially when evidence exists that the taxpayer or third-party representative, acted with willful intent, fraud or simulation.

In addition to simulation regulations, we also applied norms on construal criteria. Article 118[8] of the National Tax Code (CTN, as per the Portuguese acronym), which establishes that the legal definition of generating event shall not be construed according to the legal validity of the acts effectively performed by taxpayers, responsible parties or third-parties, as well as the nature of their purpose or effects. This mechanism provides for the enforcement of the tax laws upon transactions based on null actions and businesses, such as simulated ones. These cases were also subject to the anti-tax avoidance measures foreseen in the Income Tax legislation. The Only Paragraph in Article 219 of the Rules[9] enables the inclusion of the income earned, regardless of the denomination of the income, the nature, species or existence of entitlements or agreements, in the tax base, provided it stems from the actions or business that, owing to their purpose, have the same effects than those foreseen in the specific tax incidence norm.

Such mechanisms constitute a legal entity that repudiates the practice of apparently legal actions in the tax field, but carry inherent legal defects, such as planning schemes. It is worth highlighting that taxation is not exclusively backed by economic considerations, a fact that gave rise to legal discussions in the past. Simulation is a legal rather than an economic issue.

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[7] *"Art. 149. The audit is conducted and reviewed officially by the administrative authorities in the following assumptions: [...] VII – when evidence exists that the taxpayer, or third-party representative, acted with willful intent, fraud or simulation; [...]"*

[8] *"Art. 118. The legal definition of the generating event is construed according to an abstraction: I –on the legal validity of the acts effectively performed by taxpayers, responsible parties or third-parties, as well as the nature of their purpose or effects; II – of the effects of the actual events.*

[9] *"Art. 219. [...] Only paragraph. The calculation base is made up by all the capital income and gains, whatever the denomination thereof, regardless of the nature, species or existence of entitlements or agreements, provided they stem from the actions or businesses that, owing to their purpose, have the same effects than those foreseen in the specific tax incidence norm. (Act Nº 7.450, of 1985, Art. 51, Act Nº 8.981, of 1995, Art. 76, § 2º, and Act Nº 9.430, of 1996, Art. 25, Section II, and 27, Section II).*

The use of these rules as a measure to counter tax planning schemes features the advantage of being applied in countless situations not considered in the specific measures, such as transfer pricing rules, international tax transparency regulations and the measures on transactions with preferential taxation countries or regimes. Nevertheless, the Brazilian experience has revealed that the execution of the audit requires broad legal and tax knowledge. Additionally, auditors shall rely on the means and resources for an adequate investigation.

In many cases, the audit does not succeed as desired, moreover when the taxpayer refuses to render information on the transactions with its foreign related companies. Shielding suspicious transactions in order to hurdle the investigation process has been the main reason by which certain audits have been unsuccessful for the Administration.

5. CONCLUSIONS AND RECOMMENDATIONS

To remain competitive in the world market, businesses seek to reduce their production costs and, therefore, the tax burden. In order to achieve this purpose, they usually resort to tax planning schemes. Aggressive tax planning arises when the transactions are performed with the sole purpose of reducing tax payments and feature an illegal aspect to serve such purpose.

In order to counter and avoid the harmful effects of aggressive tax planning, countries issue legal anti-tax avoidance measures and administrative norms aimed at facilitating the control of international transactions. Noteworthy among the administrative measures in Brazil are the special control measures for large taxpayers and the implementation of the Public Digital Record System (Sped, as per the Portuguese acronym).

Controlling international tax planning also requires an advanced management and risk assessment system. The studies undertaken from specific cases may render widely satisfactory results. Nevertheless, this new context demands a more courageous approach by tax administrations. We believe an increasing commitment among tax administrations is highly desirable toward the future, with encouragement and facilitation in terms of the sharing of information, experiences and results among the different countries. Tax Administrations shall be prepared to learn from all such experiences and find solutions suitable for their own contexts. This means that,

in the effort against international aggressive tax planning, isolated initiatives are very unlikely to reach a high degree of efficacy.

Despite the cultural differences among the different countries, tax collection rates, the levels of tax compliance and the risks posed by the economic sectors are similar. Thus, in the face of the risks emerging from international aggressive tax planning, the appropriate response from the tax administrations is closely tied to exchange of experiences and in-depth study on the subject.

Nevertheless, in order to achieve high quality operations, the tax administrations shall:

a) Perfect the management and tax risk assessment vis-à-vis tax planning;
b) Extend the information and experience exchange efforts, participating in the creation of a set of good practices aimed at countering tax planning.

Finally, it is worth remembering the words of Professor José Casalta Nabais, who stated that:

> "…the effective struggle against the multiple and varied forms of tax evasion has become a truly herculean task, especially for the administrations with democratic foundations. Nevertheless, this struggle shall be relentless and I mean relentless in terms of achieving minimum standards of success to avert the risk of seeing the very democratic State collapse without help or remedy."

This is the current major challenge facing tax administrations.

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Case study

Topic 2.1

EMERGING RISKS IN AGGRESSIVE TAX PLANNING

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During the last several months, in the United States and several European and Asian countries, the activities of our citizens and bankers in bank secrecy jurisdictions, became unusually public as information revealed the deliberate attempts to avoid disclosure and reporting rules, and thus the loss of significant tax revenue of financial accounts in these jurisdictions. The offensive and perhaps illegal behavior of our citizens and perhaps their bankers tell an important story and represent a significant challenge to tax administrators around the world, but it is simplest close to home for the United States; our high net worth individuals should not be able to avoid their lawful responsibility for paying taxes by moving assets or income offshore as a means of avoiding US taxation.

We have been particularly active in this area in the past months, and much more is in the works. Some of these activities I can discuss publicly because they are already a part of the public record. There are other situations I can not discuss because the investigation may be ongoing. Taxpayer privacy laws generally prohibit public disclosure of IRS investigations. However, the United States Senate's Permanent Subcommittee on Investigations, based on their work and the public press reports, recently conducted an investigation and held hearings on these matters, and they issued a very thorough report of their findings. These reports and witness testimony are publicly available.

The most notable recent case in the public record involves a major Swiss bank. The bank signed an agreement with the United States in 2001 to become a Qualified Intermediary, or QI.

To become a Qualified Intermediary two items are required: First, the IRS must agree that the financial institution has an effective know your customer rules and a thorough documentation regime, and among

other things, an annual reporting to the IRS, of the income of the financial institution's clients that were or are U.S. citizens.

However, according to the statement of a former bank employee who pled guilty to assisting a wealthy real estate developer in evading $7.2 million in Federal income taxes, many of the bank's United States clients objected to having their information reported to the United States as required under a Qualified Intermediary agreement.

Rather than risk losing their clients, the former employee stated that the bank created a special category of United States taxpayers whom the bank and its employees assisted in avoiding United States taxation. In other words, the bank, seeing the rules changes and knowing that information reporting would be effective in identifying account holders to the IRS, created a series of structures and mechanisms to hide the true ownership of the accounts, and in the process, escape the reporting rules.

The IRS and the Justice Department, requested, via a John Doe summons, that the bank turn over account information on any other United States clients who used Swiss bank accounts to avoid United States income taxes. John Doe summonses are used when the identity of persons are not available to us through any other means. The summons we issued directs the bank to produce records identifying United States taxpayers who had accounts with the bank in Switzerland between 2002 and 2007 and chose to have their accounts remain hidden from the IRS.

On July 1st of this year, a federal judge in Miami approved a Justice Department request to allow the IRS to serve the summons. It was issue and we are working closely with the Justice Department to ensure that we get the information requested in the summons. This information will be used to determine if the assets in the accounts and the income the assets produced were ever taxed by the United States. In some situations the assets should not be taxed, as in the case of inheritances of accounts owned by decedents and left to their US heirs. However, each case will be judged on its own merits and if the behavior by the United States citizen is considered to be of a criminal nature, a referral to our Criminal Investigation Division (CID) will be made for their consideration.

Speaking more broadly, the IRS has a multi-faceted approach to combating offshore tax evasion. We are deploying a wide array of techniques and resources to uncover unlawful activities.

One of those tools is information reporting which is extremely effective if it used properly.

Most United States tax returns require that the filer provide information about foreign financial accounts, ownership in foreign entities, and financial statement data. In addition, a United States person with offshore accounts in excess of $10,000 during the course of the calendar year must file a Report of Foreign Bank and Financial Account or (FBAR). Information reporting requirements typically come with either civil or criminal penalties for noncompliance, or in some cases both. These penalties are invaluable in building civil and criminal cases against those who attempt to evade paying taxes.

Another tool is the Qualified Intermediary Program which I referenced earlier. In layman's terms, the Qualified Intermediary Program or (QIP) gives the IRS an important line of sight to the activities of foreign banks and other financial institutions. It also provides detailed information reporting that the IRS did not previously receive.

The Qualified Intermediary Program is critical to sound tax administration in a global economy. By bringing foreign financial institutions more directly into the US tax system, we can better ensure that United States persons are properly paying tax on foreign account activity, and that foreign persons are subject to the proper withholding rates.

The third tool in our toolkit is international agreements such as tax treaties and Tax Information Exchange Agreements (TIEAs), under which other countries agree to obtain information on behalf of the United States for use in United States tax matters. Tax treaties or TIEAs are particularly effective when we have identified a particular taxpayer and need more information about related overseas activities.

We currently have tax information exchange relationships with more than 70 countries and have expanded the program in recent years to include offshore jurisdictions such as the Cayman Islands and the Bahamas.

When investigating offshore evasion and the specific identities of US taxpayers are not known, the IRS generally uses its John Doe summons authority. As previously mentioned, these summonses are used to identify individuals, groups or classes of US taxpayers who may be involved in specific areas of tax noncompliance and who cannot be identified through other means.

The final – and important - tool that I will mention this morning is informants. Informants have been valuable sources of information for IRS civil and criminal investigations into offshore tax evasion. With the new "whistleblower" standards that reward informants, we are hopeful that we will obtain additional input on potential violations. Informants are a particularly strong challenge in any situation but especially in bank secrecy jurisdictions.

Deterrence is one of our most powerful weapons. In this regard, I am proud of the hard work the IRS and Justice Department investigators have put into these cases. As a result of their continuing work, I am confident that those who engage in these types of deliberate offshore tax evasion are very concerned right now. I believe that we owe it to the vast majority of honest taxpayers to pursue these cases aggressively, and we are committed to doing so.

We are also equally committed to respecting the rights of US citizens and corporations to engage in legitimate global commerce.

This is an important issue as each of us considers the tools we have and their effectiveness in combating the evasion of taxes and their impact on the tax gap; the difference between what is owed and paid.

In recent testimony to our Congress, my Commissioner, Doug Shulman, supported the idea of a change in law to provide more time for us to work on these cases by extending the current three year civil statute of limitations. Because of the complexity of these cases, three years is often insufficient to close the case appropriately.

Moreover, he stated that it is important that Congress continue to support and strengthen our network of tax treaties. They provide a basis for information sharing, and each time the agreement is renewed we seek more information from our treaty partners.

The confidence of ordinary law-abiding citizens cannot be taken for granted. When challenged by aggressive and, perhaps unlawful, behavior, tax administrations must move quickly and aggressively in their own right, to ensure that taxpayers who tried to move out of our view are brought back in and pay their fair share in accordance with the nation's laws in the public interest. Transparency through information reporting is a vital tool in this process.

Case study

Topic 2.2

REGULATION OF HOLDING COMPANIES AND TRUSTS

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CONTENTS: Abstract.- 1. Introduction.- 2. Trusts.- 2.1. Created pursuant to Act N° 24.441.- 2.1.1. Description and notion.- 2.1.2. Parties.- 2.1.3. Types.- 2.1.4. Economic relevance.- 2.1.5. Tax treatment.- 2.2. Foreign trusts.- 2.2.1. Differences with the national legal entity adopted for a trust.- 2.2.2. The Hague Convention of 1985: Trust.- 2.2.3. Ineffectiveness based on fraud pursuant to Argentine Law.- 2.2.4. Tax treatment.- 3. Holding companies.- 3.1. Regulatory notions.- 3.1.1. Control of the registration of foreign corporations.- 3.2. Tax treatment of holding companies.- 4. Applicable legislation for foreign trusts and holdings: curbing tax abuses.- 4.1. Specific regulations.- 4.2. General regulations.- 4.3. Anti-tax haven measures.- 4.4. Money laundering prevention.- 5. Experiences.- 5.1. Trusts.- 5.2 Holdings.-. 6. Strengthening tax control management.- 7. Prospects and recommendations

ABSTRACT

In 1992, Argentina adopted the worldwide income criterion, and issued the pertinent legislation in 1998. Subsequently, protection mechanisms for the national tax base were introduced, such as regulations on transfer pricing, thin capitalization, international tax transparency, tax havens, among others.

With regards to the holdings and trusts domiciled in foreign jurisdictions, there are certain specific tax regulations aimed at curbing potential abuse, such as the case of inclusion of certain holding schemes on the list of countries and zero or low taxation jurisdictions and the assumption, admitting evidence to the contrary, with regards to the distributions made by foreign trusts, to the benefit of residents in the country.

On the other hand, in addition to the enforcement of the worldwide income criterion there are general mechanisms to deter international tax planning strategies, such as the economic reality principle; the general assumption of unjustified acquisition of wealth and particularly, several anti- tax haven provisions.

Likewise, other government agencies work to deter abuses with such financial instruments and with offshore activities in general. In this respect, money laundering prevention regulations are worth highlighting, and very specially, the regulations issued since the year 2003 by the regulatory agency of corporations of the City of Buenos Aires.

With regards to the audits' experience, we have detected the use of trusts in tax havens (with different purposes, but mainly to avail themselves of the secrecy and flexibility thereof) and holding companies, with a preferential treatment in certain countries that have subscribed Double Taxation Agreements with Argentina, thus resulting in treaty shopping.

From the experience, we introduced improvements in legislation (eliminating asymmetrical treatment fostering abuse) and vis-à-vis controls' management, increasing risk perception by way of organizational changes and on the working methodologies, including the interaction with other regulatory agencies, cooperation with Tax Administrations of other countries, etc.

As a corollary to this work, it is worth stating that financial instruments are very attractive to design tax shelters. The liberalization of financial activity and the advancement of CITs shall enable more sophisticated developments posing even greater challenges for the Tax Administrations. In the face of such phenomenon, it is vital to strengthen the control role thereof, particularly in the face of these and other complex and/or innovative financial instruments.

1. INTRODUCTION

This document addresses the regulatory framework, with special focus on the tax framework, applicable to holding companies and trusts, chiefly those domiciled in foreign jurisdictions, which may be used by resident taxpayers to design and execute international tax planning strategies, whether by their location in zero or low taxation countries as well as in other countries featuring preferential tax regimes that,

together with the tax treatment stemming from the Double Taxation Agreements subscribed, may foster tax abuses, such as, treaty shopping.

We also review control experiences, describing in particular two very illustrating case studies using trusts based in tax havens. Likewise, we briefly set forth certain treaty abuse schemes with holding companies, recently detected.

Following, we identify the improvements at the regulatory and control management level arising from the AFIP working experience.

Lastly, we set forth certain future prospects and recommendations in the form of good practices, arising from the experience of controls on these institutions in the last few years.

2. TRUSTS

2.1 Created Pursuant to Act N° 24.441

2.1.1 Description and Notion

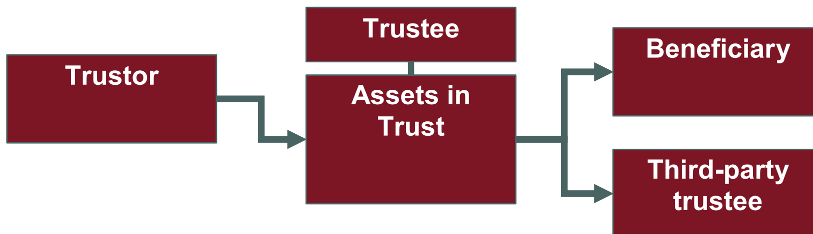
The Housing and Construction Financing Act N° 24.441 published on the Official Gazette (B.O., as per the Spanish acronym) on January 16th of 1995 for the first time addresses integrally the entity of trust, although a precedent existed in the Civil Code (Art. 2262).

The trust incorporated by such Act, N° 24.441, is based on the same entity in Anglo-Saxon Law, where the trustee is not the beneficial owner although he holds the title and usufruct of the assets, but whose function is somewhat different.

The essential feature of the trust arising from such legislation is that it constitutes a piece of property devoted to a specific purpose, which is distinguished from the traditional notion of ownership right in rem, although it coincides in certain respects therewith. That is to say, the assets assigned in trust constitute autonomous assets for a specific purpose different from the trustor estate, the trustee's estate and the beneficiary's estate, over which none holds an absolute right in rem. It constitutes a different estate is held harmless from the encumbrances on the estate of the assignor, nor the estate of the assignee for administration purposes, nor the end beneficiary.

Pursuant to Act N° 24.441, a trust exists when an individual (trustor) assigns the trust ownership of certain assets to another party (trustee), who promises to assume it to the benefit of the party designated in the agreement (beneficiary) and transfer such assets after a term or condition lapses to the trustor, beneficiary or a third-party (third-party trustee), and shall be held accountable for his actions.

The following chart graphically explains the structure of a typical trust:



The trustee holds the imperfect ownership of trust property, in agreement with the provisions in the trust agreement, since the estate assigned in trust constitutes a separate estate from the trustee's personal estate, as explained above.

The following assets may be subject of a trust: real estate property, registered or non-registered personal property, money, securities, etc., when their requirements and features may be individualized or described at the time of creation of the trust.

The trust may extinguish by lapsing of the term, a condition subsequent or the lapsing of the maximum term of 30 years, by revocation of the trustor and any other ground provided for in the agreement, such as, inadequacy or total destruction of the asset assigned in trust, conclusive court ruling declaring the nullity thereof, inability to substitute the trustee, etc.

They may be liquidated in court proceedings or according to out-of-court settlements, pursuant to the case. In general terms, they are liquidated in out-of-court settlements, unless minors or disabled parties or a public interest implied.

2.1.2 Parties

Pursuant to the foregoing notion, the following parties participate in a trust:

- **Trustor:** the party who assigns the assets (no legal restrictions apply on the parties who may act as trustors).

- **Trustee:** the party who, on the basis of such assignment, assumes the trust ownership, giving the assets the aim set forth in the agreement. Such party is accountable for its performance and shall carry separate accounting records. They may be individuals or corporations, except in the case of financial trusts that establish restrictions for the performance of such role, as it shall be explained hereunder.

- **Beneficiaries:** subject for whose benefit the trust property is administrated.

- **Third-party trustee:** subject who shall benefit from the assignment of the assets in trust (it may be the same subject as the beneficiary).

Certain role incompatibilities have been defined, such as the trustor-trustee.

2.1.3 Types

Act N° 24.441 distinguishes among trusts by establishing, on the one hand, the general requirements that shall be met in order for the entity of trust to apply, and on the other, expressly providing for the financial trust exclusively. There is no classification foreseen in the law or in any other regulation, except for theories and international experience.

It would be impossible to present the different types of trusts possible in a comprehensive and complete manner, given the versatility of the entity. Nevertheless, the following are the most widely adopted types worth highlighting:

- **Financial trusts:** those in which the trustee is a financial institution governed by Act N° 21.526 (subject to the control of the Central Bank) or a corporation expressly approved by the National Securities and Exchange Commission (CNV, as per the Spanish acronym) and the beneficiaries (investors) own the securities in trust issued by the trust (debt securities and trust participation certificates). It is essentially used in the securitization of credit assets or future flows. It is broadly used by the home appliances' businesses to securitize

the loans for the sales of such goods (or the credit card voucher issued).

Financial trusts may be classified as:

- **Based on a public offering:** authorized by the CNV to make the public offering of the trust bonds issued.

- **Not based on a public offering:** they lack such authorization. That is to say, they perform private placements of the trust bonds.

- **Regular trusts**: they may be classified according to:

    - **Collateral Trust Fund (or non-operating)**: the trust assets are used to secure the compliance with certain inherent trustor obligations or of a third-party. In the assumption of non-compliance, the trustee may dispose of the assets, pay-off the obligation and in the case of surpluses, return them to the trustor. This type of trust is similar in purpose to the mortgage or chattel mortgage with the advantage of expediting and facilitating credit management.

    - **Operating**: which may adopt some of the following alternatives:

        - **Of Administration**: its purpose is that the trustee administrates the assets assigned in trust and the proceeds and income from such administration be transferred to the beneficiary. It is usually employed to guarantee the appropriate administration of the assets of a minor or disabled individual.

        - **Real Estate Property**: in which certain individuals, as trustors, deliver money and land to the trustee (in certain cases, only the money is delivered and the trust, through the trustee, purchases the land) who shall administrate the trust that builds and delivers the units to the beneficiaries, who in their majority are trustors (they may be different). In the cases in which the trustors only assign money, they shall then decide on the purpose of the units: use, sale, rental, etc.

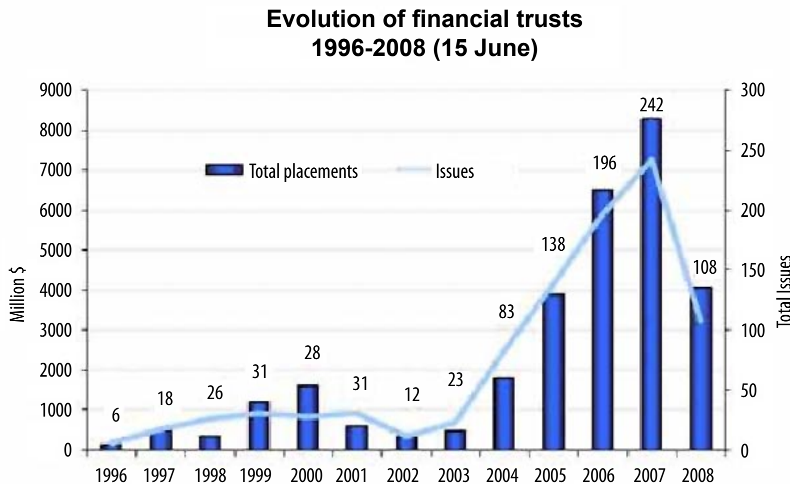
- **Agricultural**: they may be also organized as financial trusts to securitize loans for the sale of supplies and agrochemicals or collection expectations (future flows) over the sale of the harvest proceeds. They are also organized as operating trusts where trustors contribute with money and land to undertake agricultural production, distributing the profits thereafter. It is a usual modality to constitute sowing pools.

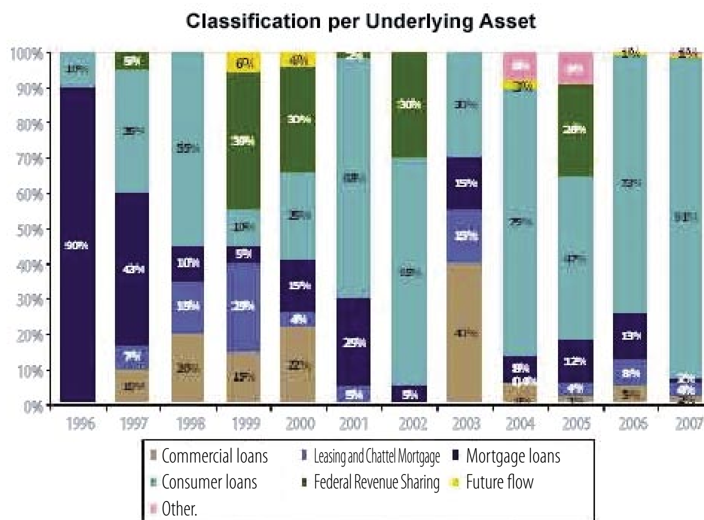
- **Public**: the State also employs this entity to finance infrastructure works and other projects.

2.1.4 Economic Relevance

After Act N° 24.441 was passed, the entity has been developed to a large extent in different businesses, particularly the modality of the financial trust, regarding which there is official information, by virtue of the controls in place for such trusts by the Central Bank and the CNV, according to the case.

Following, we set forth a number of charts were we can observe the evolution of financial trusts (in amounts and number of issues) and according to the type of asset assigned in trust.





Source: Internally drafted with data from the Buenos Aires Stock Exchange.

As it may be observed, financial trusts for consumer loans (sales of home appliances and electronics) are the most greatly developed ones, given the growing share of consumer loans as an asset assigned in trust. Mortgages, which in the beginning were the reason to pass Act N° 24.441 that carries its name, have significantly dropped in importance.

Also, real estate trusts (called “at the cost”) have played a significant role in the last few years, as well as agricultural trusts to constitute sowing pools.

2.1.5 Tax Treatment

The following charts show succinctly the tax treatment of the trust, the trustor, the beneficiaries and the trustee.

It is worth noting that although the trust does not constitute a legal entity, since it is an agreement, it does have a tax entity. Therefore, certain taxes apply thereto, under certain circumstances, and as any taxpayer, shall register with this Administration and even meet the transactions’ invoicing and registration regulations, as applicable. The trustee, as the trust administrator, is responsible for registration and filing tax statements.

With regards to the Income Tax, the regular trust (non-financial trust) becomes a seamless entity assigning the benefits to the respective beneficiaries in the assumptions in which they are the trustors as well. In the cases in which they are different subjects or non-resident subjects, the trust shall pay 35% on the income earned just like any corporation.

For financial trusts, until recently, the deduction of distributed earnings to the trust-holders was admitted, upon meeting certain requirements, by which the tax base was rendered null and the tax was, consequently, un-assessed. Recent publication of Decree N°1.207, on August 1st, pursuant to a proposal of the Federal Revenue Administration (AFIP, as per the Spanish acronym) eliminates such possibility, and financial trusts shall pay according to a 35% income tax rate.

This was somehow aimed at limiting the incentives to resort to tax planning practices based on shifting the income tax burden from the trustors to the trust, which they would then distribute, in the trust, as exempted income to the same companies that held the trust participation certificates.

The Administration, based on the experience gathered from audits, had determined that the companies selling home appliances would assign the credits (or credit card vouchers) for the sales made to such trusts; therefore, the financial profits (and even a portion of commercial profits) were shifted to the trust (that was exempted) and then distributed in the form of exempted income, the earning to the trust-holders who were definitely the same originating companies, their partners or related companies. Just as the levied income was shifted and became exempted, the expenses arising from the activity that were tied to the extension of the credits (advertising and commissions) were withheld by the originating company.

By eliminating such tax advantage, we avoid the asymmetrical treatment and achieve a greater neutrality that does not foster tax planning practices.

TAX TREATMENT OF TRUSTS

Tax	Item	Financial Trust	Regular Trust
Income Tax	Income	Exempted if it met the requirements in Art. 70.2 of the Regulatory Decree (deduction of distributed earnings)[1]. Currently, it pays a 35% rate on the income earned.	It pays a 35% rate when the beneficiary is not a trustor or is a foreign resident. If the beneficiary and the trustors are one same subject, it becomes a seamless entity assigning the income to the beneficiaries, who shall pay the tax as applicable.
Value Added Tax	Sales and Services	It is subject to the tax if it conducts levied transactions.	
Tax on the minimum presumed income.	Assets	Non-applicable. The tax is filed by the owners.	It is subject to the tax.
Personal Property Tax	Property		Non-applicable.

As regards the requirements in Art. 70.2 of the Regulatory Decree of the Income Tax Act, it is worth mentioning:

- Securitization of credit assets.
- Placement by Public Offering.
- No asset substitution except for financial placements.
- Consistency between the trust life and liabilities'' cancellation.
- Benefit made up by the income from the assets assigned in trust.

TAX TREATMENT APPLICABLE TO THE TRUSTOR, BENEFICIARY AND TRUSTEE
(non-financial trusts)

Subject	Income Tax	Tax on Minimum Presumed Income	VAT	Personal Property Tax
Non-beneficiary Trustor	No income to file owing to its status. The taxpayer is the trust.	When the taxpayer shall deem the assets assigned in trust as exempted.	Pursuant to the transfer of assets to the trust, it may be levied or exempt.	Exempt.
Beneficiary Trustor	The income distributed is Third-Category income. The trust solely assesses income and distributes it among the beneficiaries.			Applicable based on the underlying business activity.
Non-trustor beneficiary	The income earned is exempted.	Inapplicable on the assets assigned in trust.	Inapplicable.	The right to the benefit is exempted.
Trustor	Trustor fees are levied. Legal entity: Third category. Individual: Fourth Category.	Inapplicable on the assets assigned in trust.	Trustor fees constitute taxable income.	Inapplicable to the assets assigned in trust.

[1] *As previously set forth, this benefit has been recently eliminated by virtue of Decree N° 1.207/08. This Decree places financial trusts on the same footing as regular trusts (provided the beneficiaries are not trustors or are non-resident subjects) in the sense they shall pay a 35% Income Tax rate.*

The yields (interest) collected by the foreign holders of debt securities, individuals and corporations (source withholdings for the payment to foreign beneficiaries) issued by financial trusts are exempted from Income Tax, if they were placed effectively in a public offering. The earnings distributed by the trust participation certificates are exempted (assimilated as dividends).

Interest from such debt securities are exempted from VAT (when applicable) if they were placed in a public offering.

With regards to the Tax on Financial Transactions (debits and credits in bank accounts and others), the trust is subject to the tax. Nevertheless, the accounts employed exclusively in the specific performance of its activity are exempt, provided the requirements set forth in the foreign Art. 70.2 of the Regulatory Decree of the Income Tax Act, explained above.

2.2 FOREIGN TRUSTS

2.2.1 Differences with the National Legal Entity Adopted for a Trust

The Anglo-Saxon trust assumes property rights pursuant to common law and another type based on equity law. This entails, respectively, a distinction between “legal ownership” and “beneficial ownership”, which constitutes the inherent nature of the trust and implies that, for one same asset assigned to a trustee, two contemporary owners exist, a legal owner (trustee) and an equity or beneficial owner (beneficiary).

Certain opinions sustain the inadmissibility in these cases of the overriding principle of function over form, since in the trust such principle is rendered unfeasible as the latter features more than one function. This applies because in essence it is ever-changing, and thus, appropriate, among others, for collective investment. It is neither limited to private law, since a trust may exist in public law, in the limit between what is public and private.

Certain basic elements and the notion of such entity have been incorporated pragmatically in a diverse legal order such as Latin American legislation, based on the Roman Trust, to the creation of an entity that, under such denomination, would be marked by the inherent features of a new entity of undisputable value but, like its Anglo-Saxon equivalent, is also complex and involves multiple features.

The Latin American modality and the trust share the assignment of the property rights over the assets to a trustee, which is in both cases a beneficial owner.

Both entities generically correspond to the trustee businesses, but differ owing to the dual ownership feature already pointed out, regardless of the other historic and cultural differences.

In Anglo-Saxon law, the trustee and the beneficiary share the trust ownership. On the other hand, the Latin American trustee is the exclusive owner of the assets assigned thereto, during the term or condition agreed with the trustor for such purposes, the beneficiary being the holder of a right in personam against the latter.

Economic motivations have lead different Latin American countries to incorporate in their legislation and under the name of trust, the entity of the Anglo-Saxon trust, vesting upon the trustee the administration of the assets assigned under trust, to the benefit of the subjects defined and with the clear objective of providing the greatest legal certainty, limiting the risk to the parties, as in the most developed countries.

On the other hand, two relevant legislative trends may be found in the region, as regards the ownership of trust property: a) the trustee-owner and b) the trust-owner.

In the first one, the trustor assigns to the trustee the ownership of the assets, according to the applicable formalities, which are inherent therein, and according to the case, for the administration thereby, for his own benefit or a third-party's. Argentina endorses the latter theory.

In the second one, there is trust-owner, featuring an independent estate devoted to a specific purpose, but with the characteristic that it holds its own legal entity, that is to say, it is a legal subject. According to such grounds, the trust is the owner of the assets before third-parties, including the trustee and the creditors thereof.

After the enforcement of Act N° 24.441 in January, 1995, an instrument was set forth in the country to conduct trust businesses of different types, by typifying the trust agreements as an instrumental channel in the transfer of the trust ownership, the requirements for the existence of the agreement and particularly, the key element in the entity: the separate assets made up by the assets assigned in trust. Although such norm was passed with the main purpose of securitizing

financial assets, especially mortgage loans to finance housing and the construction industry–thus the name of said act -, the application in the country's economic life exceeded such scope.

Specialized theory sets forth the main differences between the trust and the national trust:

- The trust entails a division or breakdown of the property right; on the other hand, in the case of the national trust, there is only one owner (the trustee) with an imperfect ownership.
- The national trust constitutes an agreement while the trust is an entity of property rights.
- While the trust arises from a unilateral act, the national trust arises from a bilateral agreement between the trustor and the trustee.
- The settlor may assume the role of trustee, while in the national trust they shall be two different subjects.
- The trustee may not benefit from the trust, while in the national trust, the trustee may be the beneficiary.

2.2.2 The Hague Convention of 1985: Trust

In The Hague Convention of July 1st of 1985, the Signatory States set forth that they deemed the trust, just as addressed in the court of equity in the Common Law jurisdictions, -adopted with certain modifications in others-, a unique legal entity and they wished to establish common elements on the law governing trusts, considering the most relevant aspects regarding the acknowledgement thereof.

It is worth highlighting that the Convention does not intend or pursue the objective of introducing the entity of trust in the domestic legislation of the States who do not apply it. It solely seeks that the trusts applied in countries who know the entity, enjoy the status of harmonized international private law and, for those who do not apply such entity, that they implement a conflict-resolution rule that is missing in their domestic legislation, to enable to acknowledge the trust without arguing that such entity does not exist in their domestic legislation.

Likewise, it is worth highlighting that the Convention seeks to explain the trust in a more or less neutral manner with regards to traditional systems and, in spite of not being perfect, it avoids the issue of equity and division of property rights (inherent in Anglo-Saxon law), endorsing the principle of special or separate assets.

But maybe the most relevant notion worth highlighting is the acknowledgement, in such a significant sphere such as The Hague Conventions, of the relevance of this instrument.

2.2.3 Ineffectiveness Based on Fraud Pursuant to Argentine Law

Legal theory, even case law, considers that in the assumption a party pursues fraud against Argentine Law based on foreign trusts, such act is rendered ineffective pursuant to articles 1207 and 1208 of the Civil Code.

Our legislation has deemed that the trusts based in zero or low taxation jurisdictions or not, according to the typical form of an administrative trust, do not necessarily imply a violation to the Argentine tax regulations when they are legitimately and reasonably structured, as follows:

- The business purpose has been determined (generally, legal protection, legal certainty, inheritance matters, etc.).
- A genuine assignment exists from the trustor to the trustee.
- Such assignment is irrevocable.
- There is no control and decision by the trustor over the assets assigned.

2.2.4 Tax Treatment

- **Income Tax:** foreign trusts are not subject to taxation, to the extent they exclusively earn foreign income. As regards residents:
    - o **Individuals:** the foreign income earned by the beneficiary constitutes second-category foreign income. All the distributions made are deemed income, unless evidence to the contrary exists showing that no benefits were obtained or accrued from the years prior to the last one elapsed, including, in both cases, capital gains and other acquisitions of wealth. Should the taxpayer prove, as mentioned before, that the distribution exceeds the benefits, only the portion of the distribution corresponding to the latter shall be deemed income.
    - o **Corporations:** income earned from corporations in their capacity of beneficiaries, including the portion that does not correspond to the benefits mentioned in the foregoing item (vis-à-vis individuals or natural persons) or exceeding them, unless they are the trustor or equivalent entity, shall be deemed foreign third-category income.

- **VAT:** exempted transactions, except for services rendered to registered foreign subjects and used in the country for economic purposes (services' imports).

- **Taxes on the Minimum Presumed Income:** it is not subject to the tax. The securities issued owned by Argentine residents (corporations) are levied.

- **Personal Property Tax:** the assets assigned in trust are exempted (irrevocable trust). The securities issued owned by Argentine residents (individuals) are levied. The provision in Art. 26 of the tax law could apply when the foreign trust (in countries that do not apply the system of ownership of private securities)[2] owns assets in the country. In such cases, it is understood that they belong to individuals domiciled in the country (without admitting evidence to the contrary) and are subject to the tax. It does not expressly refer to trusts but it is defined as one of the assumptions of foreign assets assigned. In such cases, the substitute responsible party is subject to the tax.

3. HOLDING COMPANIES

3.1 Regulatory Notions

There is no specific law governing the existence and performance of the holding companies based in the country or in foreign jurisdictions, except for a regulation issued by the regulatory agency of corporations of the Autonomous City of Buenos Aires, as explained hereunder.

Such regulation of the Regulatory Agency of Corporations (IGJ, as per the Spanish acronym) arises after the tragedy occurred in a disco ("*Cromañón*" in the neighborhood of Once in the Autonomous City of Buenos Aires) where tens of youngsters died, in which the real estate property where the disco operated featured a title deed in the name of a foreign corporation.

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[2] *Regulations deemed that the presumption only comprises corporations, companies, permanent establishments, wealth or exploitations, domiciled, or otherwise, based in foreign jurisdictions, which by their legal nature or charter of incorporation feature the core activity of making investments outside of the jurisdiction of the country of incorporation and/or may not undertake therein certain transactions and/or investments expressly determined in the legal system or charters governing them.*

In this framework, our country regulated the treatment of holding companies, defined as investment entities or special purpose entities, which belong to a group, whose headquarters and controlling companies are chartered and domiciled in a foreign jurisdiction and subject to the laws of foreign countries. This is how we identify groups of corporations in which such special purpose entities, in the framework of group actions, receive investments from third-parties and channel them towards active corporations.

Such special purpose entities must file a statement expressing that they are effectively a vehicle for investments and render the group's organizational chart and the identity of the partners.

They are not required to report and meet certain requirements (Resolution 7/03). Such obligations shall be met by the mother or controlling companies (statement of assets and activities in the foreign jurisdictions, identification of the partners, information on potential operating restrictions in the country of origin, etc.).

The IGJ refers the transactions of such vehicle entities to the AFIP (specifically, offshore companies) so the latter may determine the legitimacy thereof.

Following, we shall briefly review the legislation issued by the IGJ, on the relevance thereof, in addition to the fact that it was an unprecedented experience in the region, which has triggered interest from international observers.

3.1.1 Control of the Registration of Foreign Corporations

In Argentina, a number of foreign corporations are operating by virtue of a more favorable legislation, with their headquarters or core business in the country. This has lead the IGJ of the Autonomous of Buenos Aires, to issue a number of resolutions with the purpose of verifying the appropriate framework thereof in the applicable legal provisions and their registration with the Public Registry of Commerce pursuant to articles 118, third paragraph and 123 of the Commercial Corporations' Act N° 19.550.

Such framework seeks to distinguish among corporations that operate effectively in a foreign country and also wish to operate in Argentina making their productive investments in this framework, from those whose purpose conceals a breach of Argentine laws on the grounds

that they are subject to a foreign law, employing such structures for illegal purposes.

The IGJ is a Registry of the Autonomous City of Buenos Aires pursuant to Act N° 22.315, presently in effect. It functions as a registry as well as a comptroller. Its authority as a registry entitles it to carry the National Registry of Corporations and Foreign Corporations, among other powers. By virtue of the auditing functions, under the scope of its competency, it may require information and any documentation deemed necessary to fulfill its task, undertaking investigations and inspections for which purpose it shall examine the records and documents of corporations, request reports from their judicial, administrative and law-enforcement authorities, when the events under the jurisdictions thereof may require the intervention of the public authorities.

The IGJ has prepared a series of legal proceedings against offshore corporations that were warned to comply with Argentine legislation and failed to regularize their situation according to Resolution N° 7/03, having sent thousands of notifications against entities who failed to become nationalized, by not certifying the ownership of significant assets in their countries' of origin or other jurisdictions.

Such corporate regulations were issued as of 2003, with the purpose of determining compliance with Article 124 of Act N° 19.550 (Commercial Corporations), combating the illegal use of corporations and concealment of the ownership of assets for tax purposes, highlighting among others[3]:

- **Resolution 7/03:** requirements for the identification of the actual owners of the shares, in the case of foreign investors, determining their origin, defining their responsibility and combating fraud by third-party corporations.

- **Resolution 8/03:** obligation to register the isolated acts performed by foreign corporations with regards to real estate property.

- **Resolution 12/03:** foreign corporation's compliance with Argentine Law, when the IGJ determines they shall be governed by Article 124 of the Commercial Corporations' Act.

[3] *IGJ resolutions may be queried at:* http://www.jus.gov.ar/registros/IGJ/. *In general, the regulations mentioned herein may be downloaded from:* http://www.infoleg.gov.ar. *In the specific area of taxation, we recommend visiting the AFIP Web page:* www.afip.gov.ar *(E-library).*

- **Resolution 22/04:** special purpose entities are exempted from Resolution 7/03 and corporations are required to abide thereby.

- **Resolution 2/05:** failure to register in the Public Registry of Commerce of foreign corporations lacking the capacity and legitimacy to act in their territory of creation.

- **Resolution 3/05:** disclosure set forth by Article 118, Section 2 of the Commercial Corporations' Act in the case of corporations or limited liability companies or companies chartered under a structure unknown to Argentine laws.

- **Resolution 4/05:** regulations issued to provide for the efficacy of the regulatory system set forth in Act N° 19.550, for the incorporation of such companies as well as the legitimacy and disclosure of their exertion of rights.

- **Resolution 5/05:** exemption of foreign corporations from the reporting requirement on the cancellation of their registration in their place of incorporation.

- **Resolution 9/05:** failure to register or report irregularities or ineffectiveness for administrative purposes of the agreements adopted in shareholders' meetings or meetings of associates, in which the companies who have failed to file the statements as required by articles 3º and 4º of Resolution 7/03 participated exercising their voting rights.

3.2 Tax Treatment of Holding Companies

No advantages are in place for the use of holding companies based in the country, by virtue of the fact that they receive the same Income Tax treatment as any other resident corporation (corporation, which as such, is subject to the tax):

- Foreign dividends are levied as well as capital gains for the sale of shares from foreign corporations.

- The negative income produced by the sale of shares of foreign companies result in specific losses, and as such may be only set off with future income from the same source.

The income from the sale of shares of national corporations is levied by Income Tax in the case of resident holdings but exempted for non-resident subjects, except in the case of shares whose beneficiaries are offshore corporations. In such context, the incentive for foreign subjects of investing directly, and not through a holding company, is evident.

Likewise, income taxes apply on the ownership of shares of foreign corporations.

4. APPLICABLE LEGISLATION FOR FOREIGN TRUSTS AND HOLDINGS: CURBING TAX ABUSES

4.1 Specific Regulations

- Inclusion of some sort of holding system on the list of zero or low taxation countries and systems (“closed list” included in Art. 21.7 of the Regulatory Decree of the Income Tax Act). Consequently, the protection mechanism foreseen for transactions with the countries or systems included on such list apply thereto.

- Presumed income based on the distributions performed by foreign trusts to the benefit of resident subjects, unless evidence to the contrary exists.

4.2 General Regulations

- The Principle of Worldwide Income, incorporated since 1992 (Act N° 24.073 published on the Official Gazette on 04/13/92) whose regulatory decree was issued in 1998 (Act N° 26.063 published on the Official Gazette on 12/30/98), incorporating transfer pricing regulations, anti-deferral provisions (international tax transparency) and anti-thin capitalization provisions, among others.

- Presumption of unjustified acquisition of wealth, in general by non-registered assets or bloated or fictitious liabilities, unless evidence to the contrary exists.

4.3 Anti-Tax Haven Measures

A closed list has been created of countries deemed to be zero or low taxation jurisdictions. It includes domains, jurisdictions, territories, member States or preferential tax regimes.

This list shall exclude those establishing the effectiveness of an information exchange agreement subscribed with Argentina and, additionally, those which by virtue of their domestic legislation shall not argue bank, stock exchange or any other type of secrecy, upon the request for information by the applicable Tax Administration or, otherwise, which establish Income Tax amendments in their domestic legislation in order to adjust it to the international standards on the matter that render the condition of zero or low taxation jurisdiction null.

The transactions therewith trigger the following tax consequences for resident subjects:

- Analysis of the transaction based on transfer pricing regulations (and compliance with the respective reporting and documentation requirements).

- Proving the effective payment to deduct outlays benefiting counterparts based in such jurisdictions.

- Enforcement of international tax transparency, when the country's residents own shares in corporations based in such countries (anti-deferral provisions), according to the passive income.

- Presumption of unjustified acquisition of wealth by the income from such countries or systems, unless evidence to the contrary exists, for example, that such income arises from activities effectively performed by the taxpayer or third-parties in such countries or stems from duly filed placement of funds.

- Enforcement of the maximum presumption of income (100% of the payment) for the application of the tax withholding to the non-resident party as interest. In such cases, the local paying entity (for example, a corporation) has no limitations as to the deduction of the interest paid (that is to say, no anti-thin capitalization rules apply for the interest benefiting subjects domiciled in such countries; nevertheless, a 35% withholding applies on the payment, with which it is immaterial to leave the income in the country or transfer it to a foreign jurisdiction via an interest payment, that is to say, there no tax saving).

We shall also deem inapplicable the Income Tax exemption on the income from unlisted shares benefiting offshore corporations. In such

cases, the Argentine buyer shall withhold the tax. For such purpose offshore corporations are understood as those domiciled or based in a foreign country, and whose core business owing to their nature or charter of incorporation is to make investments outside of the jurisdiction of the country of incorporation and/or those banned from performing therein certain transactions and/or investments expressly defined in the legal or statutory system governing them.

The Personal Property Tax rate for such corporations is 0.75%. In the case of off-shore corporations, the paying entity acts as the substitute responsible party, with a higher 1.5% tax rate. This entails that the effective taxpayer replaced the corporation in the payment of tax and shall later claim the applicable refund thereto.

Tax issues relating to tax havens have been treated inconsistently. That is to say, we lack a comprehensive vision of all the tax implications emerging from the relations or activities undertaken by the residents with the entities chartered in such jurisdictions.

In certain cases, for example, in order to identify tax havens, we resort to the black list (as mentioned above, pursuant to Article 21.7 of the Income Tax Regulatory Decree) while for the other assumptions, vague and inaccurate reference is made to certain typical features of offshore corporations.

Likewise, the work of the IGJ in controlling the registration of offshore corporations is worth mentioning. In such respect, the IGJ shall not accept the registration of corporations that are unable to conduct businesses in their country of origin, allowing them to become nationalized if they wish to do so. Special purpose entities are exempted. Notwithstanding, pursuant to the foregoing, their records shall be submitted to the consideration of the AFIP.

In such respect, it is worth highlighting that the IGJ additionally includes “non-cooperating” companies in offshore jurisdictions.

All the documentation filed with the IGJ shall be certified, translated and an apostille shall be attached.

4.4 Money Laundering Prevention

Act N° 25.246 regulates the issues relative to prevention and punishment of asset laundering. The Financial Information Unit (FIU)

is the control body that files cases with the Courts and receives the suspicious transactions' report (STR) from the subjects required to report.

The AFIP is held accountable by the FIU for filing the STR as one of its roles, identifying uncommon transactions, unwarranted, of unusual or unjustified complexity.

Determining the existence of trusts and offshore holdings shall surely warrant the submittal of an STR. In such regard, it is worth highlighting that the AFIP is bound by tax secrecy, except when it has reported the transaction as suspicious.

As regards the applicability, the AFIP shall report to the FIU in the case of registered subjects, when the adjustment is conducted or in the case of an official Administrative Resolution and non-registered subjects, when the events are proven.

As of 12/31/2007, the AFIP had filed 150 reports out of a total 3,134 reports completed by that date by all the subjects reporting to the FIU.

5. EXPERIENCES

5.1 Trusts

5.1.1 Case Study I: Assignment of assets by donation to a revocable trust.

- Personal Property Tax Exemption.
- Application of the Economic Reality Principle (inexistence of an actual assignment: a businessman donated USD 715 million to two trusts located in the Cayman Islands and the Bahamas, with certain specific features: 1. It was revocable, 2. It did not designate beneficiaries, 3. It designated *fiducia cum amico,* removable thereby, from whom the *trustee* shall require instructions for every investment to be made and 4. It was unable to make donations until the death of the settlor). It was understood that the economic reality indicated that the proceeds from the sale of share packages from several companies donated to such trusts by the pertinent businessman, in which the disposability of assets was maintained, entailed evasion of the Personal Property Tax. A criminal proceeding was initiated,

which was deemed inadmissible by the Courts (the lesser tax burden).
- It is currently being heard in Court.

5.1.2 Case Study II: undercover financing in the sale of oil with advance collection.

- Failure to Withhold the Income Tax on the payment of income (implicit interest) to non-resident subjects.
- We determined that foreign subjects placed funds in the country, whose yields are deemed income. It is a typical case of commodity finance:
  - Sale of crude barrels to buyers based in tax havens.
  - Advance collection of USD 680 Million (at USD 14 per barrel) with a very long term future delivery (7 to 10 years).
  - The oil company ensured a maximum price of USD 18 per barrel (a swap agreement was in place for such purpose).
  - We later discovered the issue of notes via a trust based in a tax haven securitized by the barrels to be received (securitized asset).
  - An implicit profitability for non-resident subjects was determined at USD 4 per barrel (complex transaction featuring several transactions).
- The tax claim was drafted and the omitted tax was paid, including VAT for imports of services.

5.2 Holdings

Hereunder, we describe two cases that have been recently addressed by the auditing areas:

- Treaty shopping, since holding companies (GMBH, as per the German acronym) are chartered in Austria to divert investments to other countries and take advantage of the benefits of Double Taxation Agreements (DTA).

  By virtue of such Convention and the inherent domestic legislations, certain property and specific income are tax exempt in both countries. The investments made in Austria by Argentine residents consisting in bonds, shares and other securities are exempted from the Tax on Personal Property as well their income, which is exempted from Income Tax.

This system was deemed abusive because to the extent known, the only reason for such diversion is to take advantage of the benefits of the DTA, since Austria does not levy the income from certain companies obtained in foreign jurisdictions.

Such agreement has been reported and we estimate its expiry by the end of this year.

- Exemption of foreign income (dividends) from Argentine residents, which resort to investment corporations in another country signatory of the DTA. The shares held from controlled companies based in third-party countries are delivered as a capital contribution to such holdings. Thus, the taxes applicable on such foreign income are avoided.

  The dividends distributed to the resident subject (corporation) by the holding company are governed by Article 11 of the pertinent DTA and, therefore, tax-exempt in our country. We deemed it appropriate to introduce changes to the DTA that prevent tax planning practices that result in tax avoidance, and this is still under analysis.

Both cases are under review in the Ministry of Economy. It is worth highlighting that we have recently reported the DTA with Austria on July 22nd, 2008 (External AFIP Notification Nº 6/08), as mentioned above.

6. STRENGTHENING TAX CONTROL MANAGEMENT

- Changes in regulations:
  - Elimination of the preferential treatment of local trusts (Decree N° 1.207/08).
  - Claim for the annulment of the DTA subscribed between Argentina and Austria. Review of other Agreements.
  - Strengthening the anti-abuse legislation, particularly by the use of tax havens (income from such jurisdictions).
  - Regulations to enable other agencies to counter offshore transactions.

- More and better quality information:
  - Information system for transactions between residents with representatives of non-resident subjects: General AFIP Resolution N° 1.375/00.

  - Information system on the entry of foreign income to the country: General AFIP Resolution N° 1.926/05.
  - Information system on trusts: General AFIP Resolution N° 2419/08.

- Inter-institutional cooperation with controlling bodies: Central Bank of Argentina.
  - Interaction at a regulatory level (for example, offshore, etc.).
  - Information on the foreign exchange control regime.
  - Simultaneous audits on foreign exchange brokers.
  - Working meetings.
  - Educational initiatives on inherent topics.

- Organizational changes:
  - Specialized sectors in the control of international operations, financial activity, etc.
  - Technical coordination of topics.
  - Greater communication among areas.

- Risk management:
  - Notion of complete cycle: interaction of all the control cycle links (selection and planning; audits, assessment and contentious matters).
  - Creation of risk matrices:
    - Identification of risk sectors, groups and subjects.
    - Differentiated control strategies.

- Corporate tax responsibility:
  - Meetings with corporate authorities.
  - Working groups on complex issues.

7. PROSPECTS AND RECOMMENDATIONS

Financial instruments are very attractive tools for tax planning (tax shelters).

Opening up and deregulation of markets and financial institutions worldwide, considering the important technological development of communications and IT, greatly facilitate the design and implementation of sophisticated products.

Surely, the challenges would increase in the future for the Tax Administrations, in the face of these businesses, which, in addition to

being sophisticated, are globalized, vis-à-vis the national jurisdiction applicable thereto.

In such context, it is vital to empower the auditing role thereof, particularly before these and other complex and/or innovative financial instruments.

The recommendations based on the Argentine experience are:

- As regards legislation:

  - Review national legislation and DTAs (eliminating asymmetrical, inconsistent treatments and legal vacuums). Consider a trade-off with economic policy objectives.
  - Introduce anti-avoidance measures.
  - Generate interaction among regulations.

- Strengthen the Tax Administrations performance in audits:

  - More and better quality information: a vital input in drafting and reviewing risk matrices periodically.
  - Specialized areas: international transactions; financial activity, etc. Ongoing education. Support by part-time experts.
  - Interaction with other national comptroller bodies: generate synergies that empower the role of the respective bodies, since in spite of the existence of diverse objectives, it is possible to establish areas for the coordinated efforts from such institutions.
  - International administrative cooperation with other Tax Administrations (information exchange, simultaneous audits, etc.).

Case study

Topic 2.2

REGULATION OF HOLDING COMPANIES AND TRUSTS

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I. INTRODUCTION

The Canada Revenue Agency ("CRA") certainly recognizes that the use of holding corporations and/or trusts play a major role in arranging bona fide business transactions and estate planning affairs in a tax efficient manner. However, rarely will you find an abusive tax avoidance arrangement that does not involve either the use of a holding corporation and/or a trust. There is no clear answer as to where to draw the line with respect to the abusive use of these tax vehicles, particularly on an international basis. The results of each series of transactions in which a holding corporation or trust is used will have to be governed separately by the object and spirit of each country's domestic tax law, fiscal policy and tax treaty provisions.

This paper will focus on issues arising from the use of holding corporations and trusts from a Canadian perspective when international transactions are involved, and the Canadian tax administration's reaction to addressing the results when they are inconsistent with the scheme of the Canadian *Income Tax Act* and related fiscal policy. It is first essential to set the foundation by identifying what a holding corporation and a trust are for Canadian income tax purposes.

A. What is a Holding Corporation?

Unlike in some foreign tax law, a holding corporation has no special definition in Canadian tax law. As its name implies, for Canadian tax purposes, a holding corporation is normally viewed to be a corporation created to merely hold specific assets, such as, shares, receivables, investments, royalties and other rights to income. Normally, such a holding corporation will incur minimal expenses. Holding corporations are also created as the Parent of a group of related domestic and/or international corporations for purposes of management and control versus investment purposes. To determine whether an entity is a holding corporation, it is necessary to review what the Canadian tax administration considers to be a corporation for Canadian income tax purposes – whether created domestically or in a foreign jurisdiction.

In Canada, a corporation is considered to be an entity created by law having a legal personality and existence separate and distinct from the personality and existence of those who caused its creation or those who own it. A corporation possesses its own capacity to acquire rights and to assume liabilities, and any rights acquired or liabilities assumed by it are not the rights or liabilities of those who control or own it. As long as an entity has such separate identity and existence, the CRA will consider such entity to be a corporation even though under some circumstances or for some purposes the law may ignore some facet of its separate existence or identity.

Furthermore, if an entity organized under the laws of a foreign jurisdiction meets the criteria of a corporation discussed above, regardless of how it is treated in the foreign jurisdiction, it will normally be treated as a corporation for Canadian income tax purposes. The CRA is of the view that the above definition of a corporation includes not only entities sometimes referred to as joint stock companies and limited liability companies, but also other foreign entities.

The difficulty is in classifying hybrid entities. The term "hybrid entity" refers to an entity created under a statute which combines legal rights and obligations commonly associated with a corporation, partnership or some other organizational form. Consequently, a hybrid entity may be treated as a separate tax-paying entity under the laws of one jurisdiction, while being treated under the laws of another jurisdiction as a transparent or flow-through entity whose income, gains and losses are attributed to its shareholders or owners. This difference in treatment creates tax arbitrage opportunities.

Hybrid entities exist in a number of countries, including Canada and the United States. For example, in Canada, an unlimited liability corporation ("ULC") may be created under the corporate laws of the provinces of Alberta, British Columbia and Nova Scotia. A ULC differs from an ordinary Canadian corporation in that the liability of its shareholders is unlimited, which is an attribute of a partnership. However, the CRA treats a ULC as a corporation for Canadian income tax purposes, as it is created by statute and has a separate legal existence. ULCs are used primarily by U.S. corporations with operations in Canada, as for U.S. tax purposes, a ULC can flow its income and losses to its shareholders by electing to be treated as a disregarded entity if it has a single shareholder or a partnership if it has more than one shareholder. This permits a U.S. corporate group to achieve the same result as if they filed a consolidated income tax return, which they are generally only allowed to do with corporations resident in the U.S.

Many U.S. state statutes provide for the formation of a limited liability company (LLC) which does not issue shares but rather entitles each member to a percentage interest in the company based on the member's contribution. But like a corporation, the liability of LLC members is limited to their investment. For US tax purposes, an LLC is treated as a disregarded entity or partnership, but can elect to be treated as a taxable corporation. For Canadian tax purposes, an LLC is classified as a corporation based on its legal status. However, since the Canada-U.S. income tax convention only applies to a person resident in the U.S. if the person is liable to tax there, an LLC is not eligible for treaty benefits unless it elects to be treated as a taxable corporation for U.S. tax purposes.

Several U.S. state statutes provide for the formation of a limited liability partnership (LLP), which is a separate legal entity distinct from its members and provides the members with limited liability with respect to activities outside their personal control (some statutes provide only

partial protection). The U.S. state of Delaware allows for the creation of a limited partnership (LP) which, unlike a Canadian partnership, is not required to carry on business in common with a view to profit. For U.S. tax purposes, an LLP or LP may elect to be treated as either a corporation or a partnership. For Canadian tax purposes, if the partners have only partial limited liability protection, the LLP will be treated as a partnership, and entities that do not carry on a business for profit will not be considered a partnership for Canadian tax purposes.

When classifying a foreign entity, the CRA considers not only the law under which it was created, but also the legal documents underlying its formation, and compares its key attributes to those of a Canadian corporation and Canadian partnership. An entity created by statute that has a separate legal existence and limits the liability of its shareholders or owners will generally be treated as a corporation for Canadian tax purposes. For example, in addition to the above U.S. entities and many other foreign entities, the CRA treats a Sociedade anonima (S.A.), a Sociedade anonima de responsabilidad limitada (S.A.R.L.) and a Sociedade de responsabilidad limitada (S.R.L.) as corporations.

B. What is a Trust?

While various types of trusts are defined for specific purposes in the Canadian *Income Tax Act*, trust law has evolved from a fusion of English common law and equity law. D.W.M. Waters, a leading Canadian expert on trust law, described a trust as a fiduciary relationship where the trustee holds title to property and manages it for the benefit of another (a beneficiary), the trustee and beneficiary have dual ownership of the property, and the trust property is not available to the creditor of the bankrupt trustee.[1] He also described what are commonly referred to as the “three certainties” required for a trust to be valid. If any one of the certainties is not present or if the settlor fails to transfer legal ownership or control of the trust property to the trustee, the trust is invalid. The three certainties are considered to be present when (1) the settlor’s intention to transfer property to a trustee to hold for the benefit of others is clear, (2) the property that is to form the subject-matter of the trust is clearly identified, and (3) the objects of the trust, i.e., the persons or class of persons who are to enjoy the benefit of the trust property are ascertained (i.e., named) or ascertainable (i.e.,

[1] *Law of Trusts in Canada, Carswell, 2nd Edition (1984, pp. 10-14), D.W.M. Waters*

it is possible to determine whether a person is a member of a class of beneficiaries, such as a child).

A trust is either a testamentary trust or an inter vivos trust. A testamentary trust or estate is created on the day a person dies by the terms of a will or by a court order relating to the deceased individual's estate. An inter vivos trust is a trust that is not a testamentary trust and is thus often referred to as a living trust. Taxpayers generally use inter vivos trusts that are discretionary trusts for tax planning, as they grant the trustee discretion as to whether and when to distribute trust income or capital to any particular beneficiary. Therefore, a discretionary trust provides an opportunity to achieve tax savings while maintaining flexibility over the disposition of the trust property. For this reason, trusts addressed in this paper are only inter vivos discretionary trusts.

This paper also does not address a bare trust, as a bare trust is not treated as a separate taxpayer for Canadian income tax purposes. Under common law, a bare trust relationship exists where the trustee is merely vested with legal title to the trust property and has no other duty to perform, responsibilities to carry out, or independent powers to exercise as a trustee, other than to carry out the instructions of the beneficiaries. Thus, for Canadian income tax purposes, a bare trust is treated as an agency relationship and the income, gains and losses of the trust are attributed to its beneficiary or beneficiaries.

The validity of a trust created in Canada and the rules for its administration are governed by the law of the province or territory chosen by the settlor or, if no law is chosen, by the law with which the trust is most closely connected. The trust laws of the provinces and territories generally follow common law, except for Quebec, which is a civil law jurisdiction. Trusts are not recognized under civil law. However, Quebec has enacted laws to enable persons in that province to establish a trust very similar to a common law trust.

The Hague Convention on the Law Applicable to Trusts and on Their Recognition (1985) sets out rules for the recognition by signatory states of trusts created under the laws of other states. The description of a "trust" in the Convention is similar to the common law meaning of a trust, but is wide enough to encompass fiduciary roles in civil law jurisdictions. Canada has been a signatory to the Hague Convention since January 1, 1993. The convention is implemented in Canada through provincial legislation. All but Canada's two largest provinces, Ontario and Quebec, have implemented the convention.

C. Canadian Tax Law & Administrative Practices - Corporations

Under the Canadian *Income Tax Act*, a corporation that is resident in Canada is subject to tax on its worldwide income. A corporation is considered to be resident in Canada under common law if its central management and control is in Canada. Furthermore, a corporation incorporated in a Canadian jurisdiction is deemed to be resident in Canada. However, if the corporation is legally continued in a foreign jurisdiction (i.e., if it submits to the corporate law of another jurisdiction), it will be deemed to have been incorporated in that other jurisdiction as of the date of continuance and will no longer be a deemed resident of Canada, as it will have effectively emigrated from Canada.

Similarly, a foreign corporation is subject to tax in Canada on its worldwide income if it is resident in Canada under common law or if it is deemed to be resident in Canada on a legal continuance in a Canadian jurisdiction. However, if the corporation is a dual resident under a tax treaty and it is determined to be resident in the other contracting state and not Canada for purposes of the treaty, then the corporation will be deemed not to be resident in Canada for Canadian tax purposes. A non-resident corporation is only subject to tax in Canada on Canadian sources of income and may be entitled to an exemption from tax or a lower rate of tax on certain sources of income pursuant to a tax treaty.

Domestic taxable corporations are primarily either Canadian controlled private corporations (CCPC) or public corporations and their subsidiaries. A CCPC is eligible for specific tax benefits; the first $300,000 of taxable income is subject to a lower rate of tax and a portion of any capital gains arising from a sale of shares of a CCPC is exempted from tax. A corporate group cannot file income tax returns on a consolidated basis; each corporation must file a separate return annually. However, as an administrative practice, provided the results are within the scheme of the *Income Tax Act*, the CRA allows domestic corporations that are affiliated[2] to undertake transactions to facilitate the use of their non-capital loss and capital loss pools within the corporate group. This practice is not extended to foreign corporations. Dividends can flow tax-free between Canadian corporations, whether

[2] *A corporation is regarded as affiliated with a person who controls the corporation, each person who is a member of an affiliated group that controls the corporation, or a spouse or common-law partner of such persons. Two corporations are affiliated with each other if each is controlled by one person or by the same group of affiliate persons. For this purpose, a person includes a partnership and a trust.*

or not affiliated. As a result, there are anti-avoidance rules existing within the law to ensure that this advantage is not abused.

Canadian residents have always been taxed on their worldwide income. But as far back as 1962, in a Report on the Royal Commission on Taxation, Canada recognized that foreign income of Canadian residents should be taxed under a comprehensive tax base in accordance with procedures which minimize tax deferral and the use of holding corporations in tax havens. In response to the Report, the Department of Finance issued its White Paper on tax reform which resulted in the introduction of the foreign affiliate and Foreign Accrual Property Income (FAPI) rules in 1972 which, after a comprehensive review and consultation process, became law effective January 1, 1976.

The new foreign affiliate rules allowed multi-national corporations to be more competitive in international markets by providing relief from double taxation. Generally, the profits of a foreign affiliate from carrying on an active business in another country with which Canada has a tax treaty can be returned to Canada as a tax-free dividend. As a result, taxpayers often create holding corporations in countries that are considered “tax havens” but have tax treaties with Canada to take advantage of the foreign affiliate regime. Where a hybrid entity is used, the taxpayer must ensure that the entity is treated as a “corporation” for Canadian tax purposes, as only a corporation may be considered a foreign affiliate.

The FAPI provisions were introduced to prevent Canadian individuals, trusts and corporations from offshoring funds into specifically created holding corporations to defer tax on passive income, including income from foreign portfolio investments, and on certain income from businesses not considered to be active businesses. A Canadian resident shareholder of a controlled foreign affiliate is required to report, on an annual basis, a share of the corporation’s FAPI based on the percentage of the shareholder’s equity interest in the corporation. A foreign corporation is a controlled foreign affiliate of a taxpayer resident in Canada if the corporation is controlled by the taxpayer or by the taxpayer and not more than four other residents of Canada. If the corporation is not a controlled foreign affiliate, but the Canadian taxpayer and related persons have a combined equity interest of at least 10%, tax on the income can be deferred until the taxpayer actually receives the income.

The Offshore Investment Fund Property (OIFP) legislation was introduced in 1986, as Canadians who acquired shares, indebtedness or interests in foreign holding corporations kept their interest below the 10% threshold so as not to be caught by the FAPI provisions. Where one of the main reasons for acquiring or holding such an investment is to derive a benefit from portfolio investments in such a manner that the taxes on the income, profits and gains therefrom is significantly less than the tax that would have been payable had the income been earned directly by the taxpayer, the OIFP regime requires the taxpayer to include an amount in income annually, which, in general, is determined by multiplying the cost amount of the investment by a factor based on prescribed interest rates.

The policy behind the FAPI and OIFP provisions is to tax passive income as if the properties in the underlying holding corporations were held directly by the Canadian taxpayer. To prevent double taxation, the taxpayer is entitled to a deduction or tax credit for foreign taxes paid in respect of such income.

D. Canadian Tax Law & Administrative Practices - Trusts

The Canadian *Income Tax Act* requires a trust to compute its income and file a tax return in the same manner as an individual, except that a trust is not entitled to all of the deductions and credits available to an individual. Also, the income of a trust is taxed at the highest rate of tax, while an individual can receive income tax-free if it does not exceed a certain threshold and will pay lower rates of tax on certain income levels. Like an individual, sources of income subject to tax in Canada depend on whether the trust is resident in Canada. The residency of a trust is generally considered to be the place where the trustee or a majority of trustees who manage and control the trust property reside.

A trust that is resident in Canada is subject to tax on its worldwide income. If the income of the trust or any portion thereof is paid or payable to a beneficiary in the year earned, the beneficiary must report the income and the trust is entitled to a deduction for amounts included in the beneficiary's income. However, the trust may designate income as not having been paid or payable to the beneficiary so that the income is taxed in the hands of the trust. If trust income is paid to a non-resident beneficiary, the non-resident is subject to withholding tax and a special tax on specified Canadian source income so that the combined tax rate is approximately the same as the rate of tax

that would be imposed if the income were received by a resident beneficiary. Generally, every 21 years, the trust will be deemed to have disposed of all of its capital property at fair market value and to have reacquired the property at that value and the trust will be liable for tax on any gains arising from the deemed dispositions.

The Canadian *Income Tax Act* contains provisions referred to as attribution rules, which apply to Canadian residents who have contributed property to a trust for the benefit of a spouse, common-law partner or related child under the age of 18, or where the property may revert to the contributor or persons of his choosing or cannot be disposed of without his consent. Where they apply, income and gains of the trust are included in the income of the contributor. If the beneficiary is a minor child, there is an attribution of income but not gains. These rules are intended to prevent Canadians from splitting income with a spouse or minor child, or diverting income to others while retaining control over the trust property.

A non-resident trust is generally only subject to tax in Canada on Canadian-source income. However, as with foreign affiliates and holding corporations, the Canadian *Income Tax Act* has specific rules to deal with Canadian taxpayers who transfer property, directly or indirectly in any manner whatever, to a non-resident trust for the benefit of the taxpayer or a beneficiary resident in Canada who is related to the taxpayer. The existing rules provide for two different methods to impose tax on the income of such a non-resident trust.

1. A non-resident discretionary trust is deemed to be a resident of Canada whose taxable income is the total of its Canadian-source income, its foreign property income, FAPI of a foreign affiliate of the trust, and income in respect of an OIFP. Income from an active business carried on by the trust outside Canada is not subject to tax. This puts a deemed resident trust on the same footing as a Canadian trust that uses an offshore corporation to carry on a foreign active business. A deemed resident trust is entitled to a deduction for any income paid or payable in the year to a beneficiary, other than Canadian-source income distributed to a non-resident beneficiary. Collection of tax owing by the trust is difficult, as the liability can be enforced against a particular Canadian beneficiary only to the extent that the beneficiary has received a distribution from the trust or proceeds from the sale of an interest in the trust.

2. A non-resident trust that is not a discretionary trust is treated in much the same manner as a non-resident corporation. If a Canadian resident beneficiary holds an interest in the trust with a fair market value equal to 10% or more of the total fair market value of all beneficial interests, the trust is deemed to be a controlled foreign affiliate of the beneficiary. Consequently, the FAPI rules apply and the Canadian beneficiary is required to pay tax on a proportionate share of the FAPI of the trust. Beneficiaries whose beneficial interests have a fair market value of less than 10% of the total fair market value of all interests in the trust may be subject to tax under the OIFP rules.

The CRA identified many weaknesses in the non-resident trust rules, which tax planners exploited on behalf of wealthy Canadian taxpayers. As a result, extensive amendments have been introduced and are briefly discussed below. To identify high risk transactions, the CRA has established policies and procedures for reviewing all income tax returns filed by non-resident trusts at the initial assessing stage, as well as information returns filed by trusts in respect of dispositions of taxable Canadian property.

II. THE DECISION TO USE A HOLDING COMPANY

There are many bona fide business and tax efficiency reasons to incorporate a holding company. The more common uses of holding corporations include:

- to facilitate ownership of an operating company among family members or a group of individuals who seek the limited liability afforded by corporations;

- to facilitate moving funds among a corporate group in an efficient manner to satisfy the financial needs within the group;

- to manage a large group of related companies or to facilitate internal reorganizations and corporate takeovers;

- to facilitate the transfer of tax pools among related corporations, as consolidation is not permitted in Canada for income tax purposes;

- to hold portfolio investments or shares of a private company to defer having to report investment income until the individuals receive dividends from the holding corporation (inter-corporate dividends are not taxable); or

- to facilitate estate planning.

Holding corporations are also used to achieve unacceptable tax advantages.

A. Domestic Tax Avoidance Using Holding Corporations

To place emphasis on international tax avoidance, this paper will only briefly address the use of holding corporations for domestic tax avoidance, as a comprehensive understanding of the Canadian *Income Tax Act* is required to appreciate what may be considered abusive.

Domestic holding corporations are used to achieve income splitting with family members, including minor children, to take advantage of the income they can receive tax-free or at lower rates of tax than would otherwise be imposed. It became so wide-spread that legislation was introduced to impose a tax referred to as the “kiddie tax”. However, as this tax does not apply to capital gains, we are currently identifying wide-spread arrangements where holding corporations are used to convert dividend income into capital gains to avoid the kiddie tax. Since income splitting with minor children is contrary to the intent of the attribution rules and kiddie tax rules, we are applying the general anti-avoidance rule (GAAR) contained in the Canadian *Income Tax Act* to challenge these transactions. The GAAR is briefly described under Legislative Responses.

Canada’s ten provinces and three territories impose different rates of provincial and territorial income tax. Therefore, holding corporations are being used as conduits to shift income from provinces with higher tax rates to the province with the lowest tax rate, being Alberta. This is primarily achieved by diverting interest income to a holding corporation incorporated in Alberta. For example, ABC Ltd. in Ontario owes $100 million with interest @ 5% to BCD Ltd. in Newfoundland. BCD Ltd. creates a holding corporation (Holdco) in Alberta and transfers its $100 million receivable to Holdco on a deferred tax basis. The interest income is now received by Holdco and is taxed at the Alberta rate of 10% rather than the Newfoundland rate of 16%. Holdco distributes its net interest income to BCD Ltd. as a tax-free dividend. Thus, BCD Ltd. enjoys a net tax savings of 6%. The provinces are concerned about such provincial tax shopping, as it depletes Newfoundland’s tax base by the 16% tax it would have otherwise collected and enriches Alberta’s by 10%. As the CRA administers provincial corporate taxes for most provinces (but not Alberta), we are currently considering means

to address this wide-spread problem, including applying provincial general anti-avoidance rules and legislative amendments.

Domestic holding corporations are also utilized to strip surplus without paying tax, to avoid special taxes, to take advantage of special exemptions, to transfer deductions or tax pools amongst arm's length parties, and to artificially create deductions or capital losses. Where holding corporations are used to achieve tax benefits that are inconsistent with the object and spirit of the Canadian *Income Tax Act,* we will generally apply the GAAR to deny the tax benefit.

B. International Tax Avoidance Using Holding Corporations

According to the 2001 and 2002 Reports of the Auditor General of Canada, loans and investments in foreign affiliates by Canadian resident corporations increased from $200 billion to over $450 billion between 1996 and 2000 and arrangements involving foreign affiliates had eroded Canadian tax revenues of hundreds of millions of dollars over a 10 year period. Indeed, the scope for international tax avoidance is significant and holding corporations play a major role. Among others, the more common usages of holding corporations include the following.

i) Offshoring Income

- Canadians offshore profits and growth in Canadian assets, particularly valuable patents and trademarks. After undertaking research in Canada, incurring millions of dollars in expenses and benefiting from generous tax incentives afforded by both federal and provincial governments, taxpayers transfer registered patents and trademarks for newly approved products, particularly those relating to new drugs and other pharmaceutical products, to a holding corporation created in a tax haven in exchange for shares, and contract out the worldwide selling rights, marketing, and manufacturing to other countries so that the related income and any gains from a sale of the patents and trademarks are reported in the tax haven versus Canada.

- Canadian corporations claim expenses for management fees and other fees paid to wholly owned holding corporations in tax havens, which contract the work to related corporations within the international group.

- Canadian corporations create holding corporations in tax havens that employ minimal staff (normally one employee) to buy products on their behalf in return for a fee so as to inflate the cost of the products in Canada.

- Canadian corporations that sell insurance on their products or on credit cards issued to their customers offshore the insurance premiums to holding corporations in tax havens to avoid paying Canadian tax.

- Canadian individuals create offshore holding corporations to hold portfolio investments and other investments or acquire shares in offshore holding corporations to avoid or defer tax Canadian taxation on passive income.

ii) Indirect Loans

Canadian corporations misuse Canada's foreign affiliate rules by creating "double dip" financing structures. For example, a profitable Canadian corporation (Canco) borrows money to invest in shares of a holding corporation in a tax haven (Havenco) and claims an expense for the interest paid to the bank. Havenco lends the money to a non-resident subsidiary of Canco (Sourceco), which uses the funds in its business and claims a second interest expense. Havenco then pays its net interest income to Canco as a dividend. This structure allows the corporate group to claim two tax deductions for one investment while paying little or no tax on the interest income in the tax haven and no tax on the dividends, as they are derived from an active business of a foreign affiliate. Therefore, the net result is a reduction in Canco's taxable income by the amount of its interest expense. An illustration of this "Double Dip Financing Structure" is provided in the PowerPoint slide presentation.

iii) Hybrid Entities

Multinational corporate groups use hybrid entities to import interest expense into Canada to reduce the cost of an offshore investment by taking advantage of the mismatch in treatment of the entities by the countries involved. For example, a "tower structure" is used to create an interest expense in Canada. First, a Canadian corporation (Canco) and its Canadian subsidiary (Cansub 1) form a U.S. limited partnership, which obtains a loan from a Bank and uses the borrowed money to invest in shares of a Canadian ULC (Cansub2). Cansub2

uses the funds to invest in shares of a U.S. LLC (U.S. Sub), which loans the funds to a U.S. operating subsidiary (U.S. Sub 2). In Canada, the Partnership is treated as a partnership and the other entities are treated as corporations. Thus, for Canadian tax purposes, Canco and Cansub 1 can deduct their share of the interest expense incurred by the Partnership and U.S. Sub flows its interest income through Cansub 2 to the Partnership as tax-free dividends (as they are derived from an active business of a foreign affiliate). The Partnership then uses the dividends to pay the interest owing to the Bank. For U.S. tax purposes, the Partnership elects to be treated as a corporation (U.S. Co) and Cansub2 and U.S. Sub elect to be treated as disregarded entities. Thus, the interest expense incurred by the Partnership is offset by the interest income earned by U.S. Sub and the inter-corporate dividends are ignored. An illustration of this “Tower Financing Structure” is provided in the PowerPoint slide presentation.

iv) Surplus Stripping

Holding corporations are used to enable non-residents to strip Canadian subsidiaries of their retained earnings on a tax-free basis. For example, the CRA has seen taxpayers undertake transactions whereby a receivable is created in a foreign corporation (Forco) through an offshore asset transfer to a foreign holding corporation (Holdco). Holdco is continued in Canada so that it becomes resident in Canada and, through a tax-free transfer of shares, a profitable Canadian subsidiary (Cansub) within the international corporate group is transferred to Holdco. Cansub then pays a tax-free dividend to Holdco and Holdco uses the funds to repay Forco. Thus, by importing a holding corporation, funds are stripped from a Canadian profitable corporation to a non-resident corporation without any withholding tax being imposed.

v) Treaty Shopping

Non-residents create a holding corporation (Holdco) in a country with more favourable rates of withholding tax under a tax treaty with Canada than those under the treaty with their country of residence to reduce their withholding tax on interest, dividends or royalties received from Canada. This was an issue in a recent Canadian case, *Prevost Car Inc. v. The Queen*, in which the taxpayer’s shareholders, who resided in the U.K. and Sweden, transferred their shares to a Holdco in the Netherlands to benefit from the lower withholding tax rates under the Canada-Netherlands income tax convention. The Holdco had no

office or employees in the Netherlands and was obliged to forward any dividends received from the taxpayer to its shareholders. The CRA imposed the higher rate of withholding tax on the basis that the Holdco did not have beneficial ownership of the dividends received from Canada. The Tax Court of Canada found as a fact that the Holdco was the beneficial owner of the dividends and refused to lift the corporate veil. The decision has been appealed to the Federal Court of Appeal.

Taxpayers create holding corporations in countries that have favourable tax treaties with Canada to hold taxable Canadian properties so as to avoid tax on the gains that arise on the disposition of the properties. They also continue a holding corporation from a non-treaty country to a treaty country prior to a contemplated sale of taxable Canadian property to obtain treaty relief in respect of a gain that would otherwise be taxable in Canada. This was the issue in a recent case, *MIL (Investments) S.A. v. The Queen*. MIL continued from the Cayman Islands, a non-treaty country, to Luxembourg to obtain treaty relief in respect of a gain from a disposition of shares that were taxable Canadian property. The Tax Court of Canada did not support the application of the GAAR to deny the treaty shopping benefit. This decision was not appealed, but will be distinguished by its facts. The CRA will challenge similar cases.

III. THE DECISION TO USE A TRUST

Canadian individuals have many bona fide reasons for settling a domestic trust, including for estate planning, to provide for charities, employee benefits or employees' retirement, or to attract investors (unit trusts). Offshore trusts may be set up for many of the same reasons; however, the main reason Canadians create an offshore trust is to take advantage of lower tax rates in the chosen jurisdiction and exemptions from Canadian tax provided under a tax treaty.

A. Domestic Tax Avoidance Using Trusts

Canadian residents transfer shares that qualify for an exemption from tax on capital gains to a domestic trust to shift gains from an anticipated sale of the shares to various beneficiaries who can utilize their capital gains exemption to reduce the tax otherwise payable in respect of the sale.

The CRA has dealt with several cases where Canadian individuals used tiered trusts to shift their personal income and that of their operating

companies to the Province of Alberta in order to take advantage of its low rates of provincial income tax. They do this by setting up the first trust in the individual's home province with the individual as the trustee, and a second trust in Alberta with a lawyer in Alberta as trustee. The Alberta trust is a beneficiary of the first trust and the individual and his spouse are beneficiaries of the Alberta trust. Under a contract, the first trust provides management services to the company, which pays substantial fees for the services to reduce its taxable income. The individual provides the services as an employee of the first trust, for which he receives a small salary. The first trust then distributes all of its net income to the Alberta trust. A provision in the Canadian *Income Tax Act* allocates business income to the province(s) in which the business is carried on, but does not apply because of a gap in the law that exists because, although it is a growing trend, trusts do not generally earn active business income. Consequently, income formerly earned by the individual and the company is now taxed in Alberta. The Alberta trust then distributes its after-tax income to the individual and/or loans funds to the company. The CRA is challenging these arrangements by applying a provision which permits the CRA to designate two trusts as being one trust in certain circumstances. Since it is unclear whether the provision applies in these cases, the GAAR is being applied as an alternative position.

B. International Tax Avoidance Using Non-Resident Trusts

The CRA has seen many cases where Canadians set up a trust in a treaty country in anticipation of a sale of their company the value of which is expected to increase significantly before the sale closes (e.g., during the hi-tech boom), or who simply want to shelter future gains from taxation with no sale in mind. Provided the trust is not deemed to be resident in Canada, gains realized by the trust qualify for an exemption from Canadian tax under a treaty. The gains can then be distributed to a Canadian beneficiary as a tax-free capital distribution.

Most offshore trusts arrangements are structured to avoid the non-resident trust rules in the Canadian *Income Tax Act*, which would deem the trust to be resident in Canada if a Canadian resident has directly or indirectly transferred property to the trust for the benefit one or more related Canadian beneficiaries. For example, Mr. X asks a non-resident friend to settle a trust for the benefit of his family members and to appoint a trustee resident in a treaty country that does not tax capital gains. A holding company (Holdco) is incorporated in Canada and issues common shares to the trust for a nominal amount. Mr. X.

then sells his shares of a wholly owned operating company to Holdco for their fair market value in consideration for preference shares with a fixed redemption value equal to that value. Several years later, the trust sells its shares of Holdco and claims a treaty exemption in respect of its gain from the sale.

The following are examples of other abusive schemes identified by the CRA:

- Canadian residents transfer shares to a Canadian trust so that the transfer can be done on a tax-deferred basis, and shortly after change the trustee so that the trust becomes resident in a treaty country. The trust then sells the shares and claims a treaty exemption in respect of the resulting gain. The Canadian *Income Tax Act* contains rules to tax accrued gains on properties of residents who emigrate and the deemed residency rules apply because the beneficiaries are related to the Canadian contributor. The taxpayers argue that the emigration rules do not apply because the trust was a factual resident and then a deemed resident and therefore it was at no time a non-resident for Canadian tax purposes, but is entitled to the treaty exemption because the trust is not resident in Canada for treaty purposes. This scheme was widely marketed and, in the first year, resulted in assessments of 72 trusts to deny treaty exemption claims totaling $235 million.

- Canadian corporations set up Health and Welfare trusts in tax havens, allegedly to administer self-funded private health services and/or insurance policies for employees. But after claiming large deductions for contributions to the plan, the corporations use the funds other purposes. The CRA has audited 35 plans in respect of which deductions totalled $104 million.

Depending of the facts of the particular case, the CRA may take the position that the trust is a sham or that the Canadian is a de facto trustee and the appointed trustee merely an agent and thus the trust resides in Canada. We may also argue that the trust is factually resident in Canada or that the deemed resident trust rules apply. Lastly, we apply the GAAR to challenge these arrangements. There is no Canadian jurisprudence on these offshore trusts, as many taxpayers have settled their affairs and paid their taxes. The first trial involving an offshore trust arrangement was heard in July 2008. We are awaiting the court's decision.

IV. LEGISLATIVE RESPONSES

A. Transfer Pricing Legislation

Canada introduced comprehensive transfer pricing provisions in 1997 to protect the Canadian tax base by encouraging taxpayers to observe the arm's length principle when determining prices for services, tangible property and intangible property traded across borders between related parties.[3] These rules:

- require Canadian taxpayers to conduct cross-border transactions with non-arm's length parties on terms and conditions that would have been made or imposed had the parties dealt with each other at arm's length;

- require taxpayers to provide contemporaneous documentation to the CRA to show that the steps taken to ensure that the terms and condition of their transfer pricing transactions satisfy the arm's length principle; and

- impose a penalty, in certain circumstances, where a taxpayer fails to make reasonable efforts to determine and use arm's length transfer prices or arm's length allocations in respect of transfer pricing transactions.

Where the transactions may reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit, the transfer pricing provisions allow the CRA to adjust the amounts to reflect the quantum or nature of the amounts that would have been determined had the participants been dealing at arm's length. This is particularly helpful with respect to transactions involving the transfer of intangible properties and the provision of services to holding corporations in tax havens.

[3] *Canada's transfer pricing rules conform to the 1995 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by the Organisation for Economic Co-operation and Development (OECD).*

B. Foreign Accrual Property Income (FAPI) Provisions Revised

With only minor amendments made to the foreign affiliate and FAPI rules since their introduction in 1976, by the early nineties many flaws in this legislation promoted tax avoidance. Therefore, extensive amendments were made to the foreign affiliate and FAPI provisions, effective for 1995 and subsequent years. A number of definitions were introduced and the differences between active business income, which could be brought back to Canada as tax-free dividends, and FAPI were clearly set out. In addition to income from investments and property, FAPI was extended to ensure that it would no longer be tax effective for Canadian residents to divert to offshore holding corporations such things as:

- income from accounts receivable (as Canadian corporations were factoring accounts receivable offshore to holding corporations);
- insurance premiums from insuring Canadian risks of a person resident in Canada, a property situated in Canada, or a business carried on in Canada;
- income from indebtedness and lease obligations of persons residents in Canada or in respect of a business carried on in Canada; and
- income from providing services, such as management, insurance or engineering services, for or on behalf of a Canadian taxpayer.

Changes to anti-avoidance rules were also introduced to ensure that shares or partnership interests were not acquired or issued to avoid the FAPI provisions.

C. Indirect Loan Provision Introduced

Specific anti-avoidance rules were introduced effective for 2000 and subsequent years to address indirect loans made by Canadian corporations through holding corporations and other entities, including trusts and partnerships. Where a non-resident person other than a controlled foreign affiliate of the Canadian corporation owes an amount to an intermediary (e.g., a holding corporation), and it is reasonable to conclude that the intermediary entered into the transaction because the Canadian corporation made a loan or transferred property, either directly or indirectly, in any manner whatever, to or for the benefit of any person or partnership, the non-resident person is deemed to owe to the Canadian corporation an amount equal to the amount owing to the intermediary. Therefore, the foreign affiliate system cannot be

misused to convert interest income into tax-free dividends through indirect loans made by Canadian corporations to holding corporations set up in tax havens.

D. Foreign Investment Entity (FIE) Rules Introduced

As noted above, the OIFP legislation was introduced in 1986 to tax income that was not caught by the FAPI provisions when a Canadian resident acquired an interest in an offshore property to derive a benefit from portfolio investments. However, the OIFP provisions were seldom applied because they were limited in scope and it was difficult to obtain foreign information. As a consequence, the OIFP legislation is being replaced with the foreign investment entity (FIE) rules.

Although the intent of the existing OIFP legislation and the proposed FIE rules is similar, the FIE rules are more comprehensive and extend the taxation of foreign income to all Canadian residents who hold a participating interest in a non-resident entity, including foreign trusts and foreign affiliates. The FIE rules will apply to investments in a non-resident entity that carries on an investment business or owns investment properties with a value exceeding 50% of the value of all properties, and to investments in a “tracking entity” that earns income or gains determined by reference to the production or use of property, unless the taxpayer can demonstrate that it falls under a specific exemption, which are very narrow (e.g., controlled foreign affiliates subject to FAPI rules). The FIE rules provide three methods of computing the annual amount of income to be included in the Canadian resident’s income. The accrual income method, which computes income by multiplying the designated cost of the interest (cost plus prior year income inclusions) by a prescribed interest rate, applies unless the taxpayer elects to apply either the mark-to-market method, which computes income based on the increase or decrease in the fair market value of the interest, or the accrual method, which computes income based on the income or losses earned by the entity. Extensive foreign documentation must be provided if the taxpayer elects to apply one of these methods so that auditors can verify the computations.

The FIE legislation interacts with a number of other provisions of the Canadian *Income Tax Act*. For example, the proposed FIE rules include a provision that links the FIE and FAPI rules to counter schemes that have allowed Canadian-resident taxpayers to avoid the FAPI rules by ensuring that an offshore corporation is not a controlled

foreign affiliate of any person resident in Canada. The FIE rules will also apply if the taxpayer holds an indirect interest in a non-resident entity. Consequently, taxpayers cannot avoid an income inclusion by inserting an intermediary between themselves and the FIE.

E. Non-Resident Trust Provisions Revised

In 1999, Canada proposed significant amendments to the non-resident trust rules in response to concerns about their growing use to avoid Canadian tax. The gaps in the existing law have allowed trusts to avoid the deemed residency rules and to argue that, even when they apply, the trust is entitled to exemptions from Canadian tax. It is also difficult to collect taxes owing by the trust, as a Canadian beneficiary is only liable to the extent of distributions received from the trust and such distributions are subject to the trustee's discretion.

The proposed amendments are very complex and consequently are still being considered by our Senate, eight years later. Briefly, a non-resident trust will be deemed to be resident in Canada if a Canadian resident directly or indirectly contributed property to the trust and will be subject to tax on its worldwide income, subject to certain exceptions. The trust will be entitled to a foreign tax credit in respect of any foreign income tax imposed on the undistributed income of the trust. The new rules will apply whether or not the trust has a Canadian-resident beneficiary, since in practice it is very difficult to determine whether the trust property will be ultimately distributed to such beneficiaries. In addition, each resident contributor and each resident beneficiary will be jointly and severally liable for the Canadian tax payable by the trust (subject to certain limitations).

Once enacted, the new rules will apply to all existing non-resident trusts. Therefore, some non-resident trusts have undertaken non-arm's length transactions whereby they sell the shares to a newly created Canadian company at fair market value to bump up the cost basis of the shares before the new trust rules become effective and then claim a treaty exemption in respect of the resulting gain. In one ongoing case, the gains totalled almost $3 billion. The CRA has proposed to apply the GAAR to deny the treaty exemption.

F. General Anti-Avoidance Rule (GAAR) & Treaties

The GAAR was introduced in September 1988 as a provision of last resort to combat abusive tax avoidance arrangements. The GAAR

applies to deny a tax benefit that would result, directly or indirectly, from an avoidance transaction or a series of transactions that includes an avoidance transaction where it may reasonably be considered that the transaction results in a misuse of a provision or an abuse of the *Income Tax Act* read as a whole.

The CRA has often applied the GAAR when holding corporations or non-resident trusts were used in an abusive manner. However, it wasn't clear when it came to such issues as "treaty shopping" or treaty exemption claims by deemed resident trusts whether the GAAR could be applied to deny treaty benefits. Therefore, the GAAR was amended in 2005 to specifically include a benefit arising from a tax treaty in the definition of "tax benefit" and to clarify that the GAAR may be applied to a misuse or abuse of Canada's income tax treaties. These amendments are retroactive to the enactment of the GAAR. In addition, as Canada negotiates or renegotiates its tax treaties, it is intended that the new or amended treaties contain limitation of benefits provisions to specifically address treaty abuses.

G. Foreign Reporting Requirements

To ensure compliance with the legislation addressing foreign transactions, Canada introduced foreign reporting provisions, effective 1996, to enable the CRA to identify Canadian taxpayers' involvement in offshore transactions, including those with non-arm's length holding corporations and with trusts.

Canadian residents must file information returns each year to provide the CRA with detailed transfer-pricing information relating to non-arm's length transactions with non-residents, and information relating to any interests in foreign affiliates, transfers or loans to non-resident trusts, distributions received from non-resident trusts, or investments in certain foreign properties if the total cost of such properties exceeds $100,000. The information gathered from these information returns are compiled in the CRA's data bases and are used as a tool and source of information for identifying potential abusive arrangements. The CRA has the authority to levy penalties if the taxpayer fails to file an information return, files late, or has knowingly, or under circumstances amounting to gross negligence, made or participated in the making of a false statement or omission in a return. These penalties can be significant, as they apply to each failure to furnish information. In a recent case, penalties amounted to $16 million over two years.

Non-residents must file a form to notify the CRA of a disposition of taxable Canadian property, either before the disposition or within ten days after the disposition. If the non-resident files the form before the disposition and remits a withholding tax of 25% of the gain or furnishes acceptable security, the CRA will issue a Certificate of Compliance and send a copy to the purchaser. Otherwise, the purchaser is required to remit 25% of the purchase price to the CRA on behalf of the vendor. The CRA may levy a penalty if the non-resident fails to comply with these requirements. This form is a key tool for identifying assets that were moved offshore by Canadians and for collecting tax if we deny a claim for a treaty exemption, particularly when assets are sold to an arm's length party.

The Canadian *Income Tax Act* includes a provision authorizing the CRA to issue a foreign-based requirement to a Canadian resident or to a non-resident person who carries on business in Canada to require the person to provide documents and/or information available or located outside Canada that may be relevant to the administration or enforcement of the *Act*. We can also seek assistance from our treaty partners in obtaining documents from foreign sources.

V. ADMINISTRATIVE RESPONSES TO AGGRESSIVE INTERNATIONAL TAX PLANNING

A. Competent Authority Policies and Practices

The Canadian competent authority will not generally negotiate cases under the provisions of a Mutual Agreement Procedure article in an income tax convention where taxes have been assessed in Canada pursuant to anti-avoidance provisions of Canada's domestic law (e.g., the GAAR). In such cases, the Canadian competent authority will usually limit itself to forwarding the information relating to the case to the competent authority of the other Contracting State with the view to obtaining relief from taxation that may be contrary to the convention from the foreign competent authority, at its discretion.

The Canadian competent authority would accept a request for assistance if a taxpayer succeeds in having an assessment that relies on an anti-avoidance provision vacated so that avoidance is no longer an issue, provided taxation not in accordance with the tax convention remains an issue. To the extent a Canadian court has ruled on the assessment, the Canadian competent authority cannot vary that decision and any assistance would be limited to presenting the case

to the other competent authority with the details of, and rationale for, the outcome of the court decision. Any relief for double taxation or taxation not in accordance with the tax convention will be possible only in the other country at the discretion of its competent authority.

Canada's proposed amendments to the non-resident trust rules are controversial in that taxing the trust on its worldwide income could result in unrelieved double taxation, as a trust deemed to be resident in Canada but also a factual resident of another country pursuant to its domestic tax law may be subject to tax on a worldwide basis in both jurisdictions at the same time. The Canadian competent authority has carefully considered this situation and, after extensive consultation, has taken the position that it would not be appropriate to cede Canadian residence of trusts subject to Canada's proposed non-resident trust rules, as there are usually no specific tie-breaker rules in tax conventions that deal with dual resident trusts and the test for residency under the proposed non-resident trust rules is neither inferior nor subordinate to other tests of residency. Similarly, we understand that the competent authority for the other Contracting State may be equally reluctant to cede the residence of a trust it considers resident in its jurisdiction. Accordingly, it is the Canadian competent authority's opinion that the negotiation of these cases with a view to settle the question of dual residence will generally not be possible or advisable, particularly where both competent authorities are known, more broadly, to be at an impasse on the matter. The Canadian competent authority notes that the provisions in tax conventions calling on the competent authorities to endeavour to resolve the question do not require them to come to a common understanding. The competent authorities are merely under a duty to use their best endeavours and not in any way required to achieve a result. This is supported by the OECD Commentary on Article 25 of its Model Convention. These provisions therefore contemplate that the result may be dual residence for a trust where the countries cannot settle the question.

The Canadian tax administration expects that most cases would not result in unrelieved double taxation, even if the question of dual residency is not resolved, as Canada's proposed non-resident trust rules anticipate the other country will not be giving up its right to tax the trust's income from non-Canadian sources and provides full relief for the foreign taxes paid by the trust, if any. Where, however, the application of these rules result in unanticipated double taxation, the Canadian competent authority will accept requests from non-resident trusts seeking relief. The Canadian competent authority will either

consider providing unilateral relief or entering into negotiations with the competent authority of the other Contracting State with a view to avoiding any resulting double taxation.

B. Centres of Expertise

The CRA created eleven Centres of Expertise in 2005, which are staffed by joint teams of tax avoidance and international tax specialists who conduct research and limited test audits to identify risk indicators for participants and promoters of aggressive international tax schemes. Their objective is to enhance the CRA's risk-assessment models, tools and techniques. The Centres have been assigned 50 projects involving financial products, tax shelters, promoters, transfer pricing, residency, insurance, hybrid entities, and treaty abuses. In July 2006, the CRA launched a website on its intranet to raise awareness among staff and provide them with information relating to aggressive tax planning issues.

C. Joint International Tax Shelter Information Centre

The Joint International Tax Shelter Information Centre (JITSIC) was established by the tax administrations of Australia, Canada, the UK and the U.S. in 2004 and was staffed by seasoned tax experts from each country to identify cross-border tax avoidance schemes and those who promote them. Japan became a member in 2007 when a second office opened in London, England. Participants exchange information relating to specific tax schemes promoted and/or carried out by residents of their respective countries within the provisions of the relevant treaties. The member countries also share best practices and experiences to assist member countries in addressing abusive tax avoidance.

D. Participation in International Forums

The CRA participates in various working parties of the OECD Committee on Fiscal Affairs, which have recently examined, among other things, issues relating to the application of tax conventions to trusts and other entities, transfer pricing issues, and the legal, practical and administrative framework to facilitate exchange of information and mutual agreement assistance. The CRA also participates in the OECD Outreach Program for non-member countries and shares its expertise with OECD member countries by providing instructors for workshops on various topics, including tax avoidance and transfer pricing.

Canada is a member of the Leeds Castle group, which superseded the Pacific Association of Tax Administrators (PATA) in 2006. The commissioners of Australia, Canada, China, France, Germany, India, Japan, South Korea, the U.K. and the U.S. meet annually to consider common tax administration issues, with emphasis on international activities.

Canada is also a member of the Seven Country Working Group on Tax Havens, which is a forum for exchanging ideas concerning tax havens at the senior working level. Representatives from Australia, Canada, France, Germany, Japan, the U.K, and the U.S. attend yearly meetings, supplemented by teleconference calls. This group strives to enhance each country's capacity to deal with tax haven issues and provides opportunities for bilateral action. Members also issue international tax alerts to their share experiences relating to schemes involving tax havens. Canada is currently leading a non-resident trust project to develop a catalogue of the legislative, administrative and compliance strategies used by tax administrations of member countries on the identification, detection and audit of non-resident trusts having resident contributors and/or resident beneficiaries.

E. Increased Audit Resources

The use of holding corporations and non-resident trusts in both domestic and cross-border tax avoidance schemes has been of great concern to Canada. As a result, our government allocated $30 million per year to the CRA in 2005 to enhance our audit resources to specifically target aggressive international tax avoidance. Our government has also approved in principle an additional $30 million per year to fund additional audit resources to identify issues and schemes involving non-resident trusts and foreign investment entities once the proposed amendments to the non-resident trust rules and the new FIE rules are enacted.

F. Training and Development

The CRA trains all tax avoidance specialists on how to identify and apply the GAAR to abusive tax avoidance arrangements. The CRA also developed a Cross Border Tax Avoidance course to train all senior auditors on how to identify and deal with abusive international tax avoidance arrangements. This course has been given to hundreds of auditors over the last two years. The CRA also plans to train 100 specialized auditors dedicated to detecting and auditing non-resident

trusts and foreign investment entities and, in particular, ensuring that the new non-resident trust and FIE rules operate as intended.

VI. CONCLUSION

Tax administrations around the world are facing numerous challenges resulting from the globalization of business, labour and financial markets and escalating advances in technology, which requires them to look beyond their own borders and consider global consequences. It has been estimated that the equivalent of one-third of the total global gross domestic product is now held in financial tax havens, being undisclosed and untaxed or under-taxed. This has raised concerns around the world about the erosion of the domestic tax base and the ability of tax administrations to maintain a consistent, fair and neutral tax system.

In Canada, there is an expanding network of tax professionals, banks and trust companies that operate internationally only too willing to assist Canadians in establishing trusts and other entitles in tax havens so that they can either hide their income or take advantage of gaps in Canada's laws. In addition, trust regimes in several low-tax jurisdictions have been specifically modified to facilitate offshore tax planning. As a result, the CRA has seen tax planning techniques involving foreign-based investment funds and offshore trusts become increasingly sophisticated and taxpayers willing to undertake more aggressive schemes each passing year. This has led to marked changes in the approaches the Canadian tax administration has taken in recent years to address aggressive international tax avoidance.

The CRA has undertaken initiatives, such as, the Centres of Expertise and JITSIC, in an effort to improve its audit coverage and has committed significant resources to enhance the training of auditors to assist them in developing assessing positions to counter abusive tax avoidance arrangements and to ensure the consistent application of the GAAR.

The CRA also actively participates in numerous international forums, like this one with CIAT, to develop relationships with other jurisdictions with a view to improving our response to the increasingly complex challenges placed upon us by ever more sophisticated and worldly taxpayers. Beyond the traditional exchange of information duties of our Competent Authorities, the sharing of information and best practices through our strategic interaction with other jurisdictions and understanding each other's laws, challenges and priorities will provide

us all with the ability to identify, detect and counter aggressive tax avoidance schemes. This will help ensure that taxpayers remain competitive while paying their fair share of tax, domestically and globally.

Case study

Topic 2.3

MECHANISMS FOR E-COMMERCE TRANSPARENCY

Ricardo Escobar
Director
Internal Revenue Service
(Chile)

CONTENTS: 1. Summary.- 2. General context.- 2.1. E-commerce in Chile.- 2.1.1. E-commerce as a state policy.- 2.1.2. E-commerce for the SII.- 2.1.3. SII strategic model.- 2.2. Legal and regulatory scope in Chile.- 3. Mechanisms for the transparency of e-commerce.- 3.1. E-commerce and transparency.- 3.2. Description of mechanisms implemented in the SII.- 3.2.1. Online tax cycle.- 3.2.2. Third-party information e-statement (tax statements).- 3.2.3. Taxpayer id instruments.- 3.2.4. Filing and paying taxes via the internet.- 3.2.5. Electronic invoice.- 3.2.6. MIPYME portal.- 3.2.7. Electronic tickets' invoice.- 3.2.8. Other relevant services.- 3.3. Difficulties and solutions.- 3.3.1. Legal aspects.- 3.3.2. Technological aspects.- 3.3.2.1. Security.- 3.3.2.2 Integrity.- 3.3.2.3. Availability.- 3.3.2.4 Communications and networks.- 3.3.3. Cultural aspects, communication and human resources.- 3.3.3.1. Experience and knowledge.- 3.3.3.2. Social culture and practices of the TA officials.- 3.3.3.3. Dissemination and promotion.- 3.3.3.4. State modernization.- 3.4. Results obtained from the mechanisms implemented. 4. Conclusions and future challenges. - 4.1. General conclusions 4.2. Future challenges.- 4.2.1. Regulatory sphere.- 4.2.2. Management.- 4.2.3. Taxation and control sphere.

1. SUMMARY

E-Commerce has become a worldwide phenomenon, by the growing economic opportunities it generates in the economic and social sphere. In simple terms, e-Commerce constitutes a new form of relating with suppliers, partners, competitors and clients for businesses, removing physical barriers by the use of IT media, applications and networks.

In the context of e-Commerce, the tax administrations play a double role. On the one hand, they must promote and apply all the potential offered by the Internet and IT solutions to perform secure transactions,

and, on the other, rely on mechanisms that facilitate the controls required to secure full compliance with the auditing tasks.

Thus, the SII has been implementing a relevant number of electronic services and products for taxpayers, with great appreciation thereby. Thus, we developed services and products focused on self-assessments and payments; taxpayer assistance; assessment and collection of the Territorial Tax; support to taxpayers' lifecycle; and electronic tax documents (electronic invoices, electronic tickets for professional fees, document stamps).

The above is part of the SII strategic plan, aimed at making its performance transparent, facilitating compliance by delivering clear, timely and accessible information to taxpayers, as well as the SII access to taxpayers' information and their commercial operations.

The strategic option adopted by the SII, aimed at prioritizing the application of Information and Communications Technologies (ICT), in the rendering of electronic services to taxpayers, as well as the development of automated tax compliance control mechanisms, has rendered important outcomes. In effect, progressively, the coverage of formalities available via the Web site has been extended, which has resulted in a number of benefits, such as: elimination of errors in the statements and applications that taxpayers file with the SII, shorter response times to their requests, and certainty in their transactions. On the other hand, the SII has increased its enforcement capacity, by an increasingly efficient management of the information recorded, data capturing directly from taxpayers' commercial transactions (such as, via the electronic invoice), and the use of IT tools for the focused analysis of taxpayers' tax behavior.

The development of this option has not been free from challenges, arising from the lack of an appropriate legal framework, and the fact we are pioneers in this type of technological innovations, among other aspects.

As a Tax Administration, the SII shall continue innovating to grant more benefits to taxpayers, with high-impact initiatives, such as the implementation of one-stop shopping systems for external agencies, the dissemination of the Electronic Invoice, empowering information exchange agreements with other tax administrations, executing e-Commerce taxation plans, payment of patents and services on the use of software, among others.

2. GENERAL CONTEXT

EVOLUTION, ENVIRONMENT AND DEFINITION OF E-COMMERCE

The Information Society in which we live with the incorporation of the Information and Communications Technologies, (ICT) has called to review a “new form of proceeding” in all spheres. The incorporation of the Internet in domestic and individual life, in the economic, political and social activities, has set forth great changes.

In the early 90s, the notion of “e-Commerce” arises for any business transaction supported by technology, *“e-Commerce”* remaining the name of the notion in Spanish as well.

For the European Commission, e-Commerce is *“Business conducted via electronic media. It comprises electronic transactions of tangible as well as intangibles, such as information and includes all the phases of the business, from online advertising, ordering, delivery, payment, post-sale service, legal consulting and the electronic support in the relations among businesses.”*

For the OECD: *“e-Commerce includes all the commercial transactions, among organizations as well as individuals, based on the transmission and processing of digital data, including text, sound and images.”*

New Business Models

The models generated in e-Commerce are based on the new forms of relation among the participants of the Internet and the parties to the operations.

B2B (Business to Business): it is a process or business operation in which only businesses participate.
B2C (Business to Consumer): it is a process or business operation in which only individuals and businesses participate.
B2G (Business to Government): operations or transactions in which State agencies or institutions and businesses participate, in which the latter provide goods and services.
C2C (Consumer to Consumer): operations involving end consumers.
C2G (Citizen to Government): operations with the participation of citizens and government.
P2P (Peer to Peer): economic relations involving individuals.

B2B2B: business processes or operations involving several businesses simultaneously.
B2B2C: business operations involving more than one company and the end consumer.

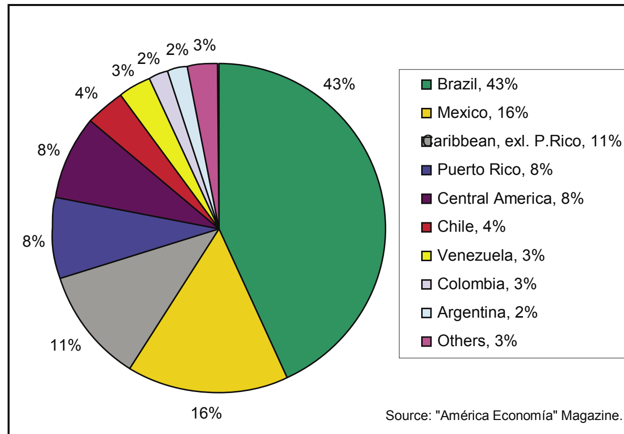
These new businesses and forms of relating originate numerous business categories with regards to the traditional ones, such as: “Outsourcing”, Marketing and post-sales services, Information delivery and treatment services, Financial Services, “New Branding”/”spin off”/ ”spin out”, establishment of meta-markets, etc. They evolve constantly at the same speed at which technology advances and it is necessary to know such processes and new forms of business, since in each stage of the value chain income and benefits with tax relevance are generated. We must identify the taxable event, taxpayer, location or source of the income etc. and approach management and tax control, as applicable.

Impact and effects on the World Economy

E-Commerce is already a broadly disseminated notion in the majority of the countries of the world. Numerous studies point out that only 25% of the searches with purchase intention actually materializes and, out of these, only 37% are conducted electronically. This means that 63% of potential consumers “bid” and “advertise” via the Internet, but end the transaction on site. In 2004, e-Commerce sales amounted to US$ 6.79 billion. The following figure shows that the evolution of sales from e-Commerce around the world is growing.

The chart hereunder shows that the undisputed leader is Brazil, with 43% of sales; Mexico is the second digital economy of the region with 16%. Chile, in spite of being a small market, accounts for 4% of the total. All the countries of Latin America feature sustained dynamics and growth of e-Commerce.

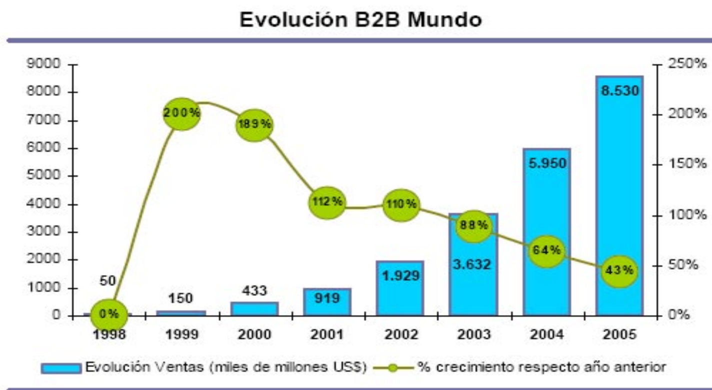
E-Commerce in Latin America:



Source: "América Economía" Magazine.

The most significant hurdles and challenges for e-Commerce in Latin America to reach its full potential are tied to improving consumers' confidence in buying online and guaranteeing a greater degree of security in transactions.

With regards to the types of e-Commerce on a worldwide level, the highest growth has been evidenced in the B2B segment. The following figure shows the B2B sales in 2005, in excess of US$ 8.5 billion.



Fuente: CCS con datos de N-economía.

After analyzing the main advantages of e-Commerce, we may highlight that:

- It constitutes a management tools that increases competitiveness.
- Internet is validated as an operational business platform.
- It does not require a business establishment with physical or effective venue.
- The relations among the parties are remote.
- Access to new markets and new businesses.

On the other hand, the challenges posed from the perspective of tax management and control:

- Identification of the place where business is conducted.
- Identification of the taxable event, the tax base and allocation or assignment of income.
- Identification of the parties participating in the operations.
- Determining the truthful documentation supporting operations.
- Determining the assets and /or services transacted.
- Modification of internal rules or legislation in this new worldwide context.

2.1 E-COMMERCE IN CHILE

In Chile, e-Commerce has been gaining momentum, especially in the last few years, in government as well as private initiatives. This has been strengthened by the large number of citizens relying on an Internet connection, which has facilitated and fostered the growth of e-Commerce transactions. That is how in the last two years (2006-2007) e-Commerce in Chile has grown by 183%, ranking second in Latin America[1].

The evolution of e-Commerce among businesses, B2B, has played a key role in Chile and accounts for almost 98% of the overall e-Commerce. The amount invoiced exceeded US$ 8 billion in the year 2005. On the other hand, the public sector has generated initiatives and projects such as e-Government, One-stop shopping system and Digital Agenda formalities.

[1] *Source: América Economia Intelligence*

In the B2B sector, the relation with the State is materialized via the www.chilecompra.cl portal, through which State Agencies conduct their procurement. Retail, construction and mining businesses participate in this portal.

On the other hand, according to the Superintendency of Banks and Financial Institutions, by mid- 2006 close to 15 million credit cards existed in Chile, out of which almost 3 million were issued by banks and more than 11 million by other entities, chiefly from large department stores or retailers.

Increasingly, more citizens take advantage of the benefits of the Internet. This has been determined by a number of surveys reporting that Chile, as of 2007, featured more than 7 million Internet users (approximately 44% of the population). Considering that in 1999, barely 647 thousand Internet users existed, the annual growth rate is approximately 700 thousand users, which enables to estimate that by 2010 approximately 70% of the Chilean population shall be Internet users[2].

2.1.1. E-Commerce as a State Policy

In the area of e-Commerce we have defined as a State policy the intensive use of information technology in the management, administration and transparency processes of the State agencies, in order to render better services to citizens, reduce the digital gap and aim at reducing the socio-economic gap separating Chile from the great economies of the world.

In the face of this, the State and the private sector developed an action plan by the name of “Digital Agenda”, aimed at turning Chile into a digitally developed country by 2010. The “Digital Agenda” is made up by 34 initiatives and 67 activities in different fields of action, conducted by the “Digital Action Group”, made up by 170 leaders from 50 public-private entities of Chile. The main objective of the “Digital Agenda” is to foster the country’s growth by the use of information technologies, modernize the State, and make the government performance and citizen participation more *transparent*. Additionally, it seeks to increase the country’s competitiveness, equal opportunities, individual liberties and the quality of life of citizens overall.

[2] *Source: Interactive Advertising Bureau www.iab.cl*

2.1.2. E-Commerce for the SII

The change in e-Commerce, supported by new technologies and the different modalities they acquire, may originate a legal vacuum and issues that hurdle the monitoring of the economic activity and the control of the transactions performed under this modality.

In this context, the Tax Administrations play a double role, on the one hand, they shall promote and apply all the potential offered by the Internet and the IT solutions to conduct secure transactions, and on the other, rely on mechanisms granting the controls required to guarantee full compliance with the auditing efforts.

Within this role, the Chilean Internal Revenue Service (*Servicio de Impuestos Internos*, SII, as per the Spanish acronym) has been firmly promoting the development of Internet-based products and services to facilitate taxpayers' tax compliance. Likewise, it has been enhancing, adjusting and focusing its auditing processes under this new technological scenario that prevails. In this regard, the SII has been increasingly introducing more electronic solutions, improving its assistance and auditing processes and making its technological services available to taxpayers, facilitating, simplifying and clarifying the tax compliance process therewith.

Pursuant to this notion, the SII is committed to provide e-Commerce solutions of excellence for all the tax lifecycle of taxpayers, by:

- Offering online services for the full taxpayer tax compliance lifecycle.
- Online services designed in line and synergy with the business administration / that strengthen the tax-activity relation.
- Online services designed to increase the tax efficiency and efficacy and the competitiveness of taxpayers' businesses.
- Growing use of these services that entail increasing digital inclusion (reducing the gap) and broadening the number of beneficiaries of ICT.
- Training on e-Commerce services to enable taxpayers to excel in their business growth.
- Electronic tax compliance that helps to organize businesses, reduces compliance costs, fosters productivity income and empowers taxpayers' competitiveness.
- Overall, it contributes to a better insertion of taxpayers in the economy, especially the smaller ones, fostering and facilitating

the performance of business and a more loyal competition among the economic agents.

For example, for a small-sized business[3], the Tax Administration should aim at:

- ✓Providing access to an Internet connection for their tax formalities;
- ✓Not requiring their presence in the SII offices to start up their business or obtain their tax identification;
- ✓Enabling to conduct all their commerce on the basis of electronic invoices;
- ✓Internet-based statements and payments;
- ✓Verifying all the proceedings with regards to online tax compliance and file it before third-parties, for example, in the case of financing needs;
- ✓In the business with foreign entities, in order to take advantage of the Free Trade Agreements, enabling its customers to control their tax compliance with the TA online;
- ✓Providing ancillary services that facilitate their tax compliance: e-invoicing, simplified accounting systems, drafting statements, tax compliance certificate, etc.;
- ✓Close their business online, expeditiously, at a minimum cost and adequately closing the tax issues, terminating a specific activity.

2.1.3. SII Strategic Model

Currently, the SII is facing a scenario that is different from previous years. With relatively high compliance levels, the map of evasion has been made up chiefly by the strongest and most sophisticated entities of tax crime and tax avoidance. Additionally, the progress in the discussion of laws such as the Customs and Tax Courts and the Taxpayers' Rights, force us to think on new services' strategies, quality of service, systematization and transparency of processes.

On the other hand, the SII shall meet an increasingly greater demand for statistical and data- processing information by the public and private entities. The amount and complexity of such requirements, as well as the enormous relevance by country of many of them, force us to think

[3] *Small-sized business: companies with an annual sales volume ranging between 100 thousand and one million Dollars, approximately.*

on a systematic mechanism to render such information. The foregoing shall be also performed under a high standard of security, in order to guarantee the full confidentiality of taxpayers' data.

Internationally, the SII also faces new challenges. The increasing importance of local businesses with international offices, the membership of Chile in the OECD and the adoption of the New International Financial Reporting Standards (IFRS) shall require radically different management efforts. These new scenarios and public responsibilities may not be approached with the current labor system and organization.

Presently, the SII is developing a plan geared at three strategic approaches: "Audits", "Information" and "Taxpayer Service". Such plan has constituted a new taxpayer assistance model. According to this model, taxpayer assistance shall be chiefly channeled via the Internet, with a personalized page, by the name of "Virtual Platform" in a model similar to the one used by banks for client assistance. It enables taxpayers to conduct all the formalities (such as, compliance with tax obligation, requirements and exchange of information, among others). We wish that the majority of interactions between the taxpayer and the SII be performed by virtual media. This shall benefit all individuals and small and medium-sized companies.

2.2 LEGAL AND REGULATORY SCOPE IN CHILE

It is worth highlighting that the enforcement of e-Commerce is conditioned by the different laws and regulations governing this type of transactions.

In the particular case of Chile, the following most relevant norms may be highlighted.

a. Legal value of the acts and contracts subscribed electronically and the electronic documents.

   Internationally, and from the standpoint of the tax interest, one of the fundamental notions is identifying taxpayers and their location. From the standpoint of Tax Audits and Management, this is the weak area with regards to the legal validity or guarantee of reliability in the identification of the taxpayers who participate in an ONLINE transaction, since there is no worldwide responsible institution.

   Technical solutions posed in the international sphere: Electronic Signature and Electronic Certificate.

b. Consumer Protection.
   It is necessary to generate trust for consumers before the lack of definitions and vacuums existing in the legal framework and the extra-territoriality of this type of commerce.

   Studies performed by international agencies[4] have set forth providing information on rights, legislation and applicable regulations in the defense of their interests, appropriate operation of the legal systems, consumer protection mechanisms in remote sales. The consumer information shall be delivered prior to subscribing an agreement: vendor identification, features of the good or service, cost of use of the long-distance communication service, right to termination and how to enforce it, validity of the offer and the delivery of the good or service, claims' procedures, post-sales services, among others.

   Chile has been spontaneously incorporating a regulatory framework required for the development of e-Commerce by issuing new legislation, updating or modifying the existing legal provisions.

   There is no Chilean tax regulation relative to e-Commerce; it is governed by the general legislation:

c. Electronic Signature and Digital Certificate Act.
   The SII previously authorizes Corporations that Render the Certification Services upon meeting the applicable requirements, granting legal validity to the digital signature in the tax sphere. The transactions' reliability levels have increased and a key momentum exists for the development of e-Commerce in the country. For other purposes, other than the tax one, the Under-Secretariat of Economy is the certifying body for businesses enabled to act as Corporations that Render the Certification Services.

d. Sales Invoice Executive Validity Act.
   This law attached upon the sales invoice and the electronic invoice (e-Invoice) in particular, the Executive Validity, making it a document with more and better enforceability tools by a summary proceeding.

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[4] *Consumer International:* http://www.consumidoresint.org/
Joint Research Centre: http://ipts.jrc.ec.europa.eu/
Organisation for Economic Co-operation and Development, OECD: www.oecd.org
North American Consumer Project on E-Commerce (NACPEC): www.nacpec.org

It entails less risk, since the payment of the electronic invoice is enforceable on a more expeditious and timely basis according to the terms set forth by law, or in the terms agreed between the selling party and the buying party.

Notifying the assignment of credit with an electronic invoice is conducted by a Public Electronic Credit Assignment Registry, carried by the Internal Revenue Service, which may be queried by the debtor, issuer and recipient of the electronic invoice, with a lower risks implied, since the holder of the e-Invoice is 100% certain of the origin, client and amount of the invoice.

e. Consumer Rights' Protection Act.
   It constitutes framework legislation governing the legal acts that, pursuant to the Code of Commerce or other special provisions, feature a commercial nature for the vendor and non-commercial ones for the consumer. It does not govern the agreements subscribed among vendors or consumers.

f. Privacy Protection Act.
   Its purpose is to provide certainty and safeguard the privacy and honor of individuals.
   - The treatment of the personal information in registries or databases by public or private entities.
   - The use and limitations of personal data.
   - The rights of data owners.
   - The use of personal data relative to economic, financial, banking and commercial obligations.
   - Treatment of data by public agencies.
   - The responsibility of individuals or corporations or public agencies responsible for personal databases and the compensation for material and moral damage occasioned by the undue treatment of data, without detriment to the elimination, modification or blocking of the data according to the requirements of the owner or court orders.

As regards the electronic data requirements, it is determined that in the face of a personal information requirement via the electronic network, evidence shall be left of:
a) The identity of the requesting party,
b) The reason and purpose of the requirement, and
c) The type of data transmitted.

It ensures users of databases the truthfulness, validity and appropriate access without violating the constitutional right of protection of privacy and the public life of individuals and their honor, which is beneficial for the security of economic, financial, banking or commercial operations.

g. Intellectual Property Rights' Law in Chile.
The law protects the rights that, by the sole event of the creation of the work, are vested upon the authors of works on the intelligence of the literary, artistic and scientific domains, whatever their expression and the related rights they determine.

Intellectual property rights comprise the property and moral rights, which protect the use, ownership and integrity of the works. It protects the rights of all the Chilean authors and the foreign authors domiciled in Chile and punishes with imprisonment for a minimum term, increased in case of second time offenses, for those who perpetrate a crime against intellectual property in any of its forms. It includes or enables to govern the specific aspects on this matter in electronic transactions.

This law, jointly with the Tax Code, punishes those who perform this commerce illegally or without meeting the legal requirements, has enabled to punish the crimes regarding copying, piracy or forgery in the area of new technologies, such as the case of the illegal copying of software and illegal reproduction of CDs and DVDs, among others, by means of illegal commerce. According to Chilean legislation, the Supreme Court case law[5], piracy constitutes a tax crime.

3. MECHANISMS FOR THE TRANSPARENCY OF E-COMMERCE

3.1 E-Commerce and Transparency

E-Commerce is developing worldwide at an increasingly faster pace. This has generated the need to develop improvements with regards to security issues of transactions and the transparency thereof.

[5] *Supreme Court - 01.10.2007 – Substance of an Appeal.*

On the other hand, this growing implementation of e-Commerce in Chile, in which an increasing number of taxpayers use this means to conduct transactions, has caused a greater complexity of the auditing role of the Tax Administration, in which in addition to promoting e-Commerce by IT tools, has modified the form of recording the identity of their users as well as each one of the transactions generated virtually.

An additional complexity, assumed by the Tax Administration, is to ensure permanent access to the information generated by the virtual transactions. The SII has been developing numerous technological control mechanisms to record the information generated in real time, but, in turn, this role generates the obligation to oversee the transparency of the control actions performed.

The notion of “Transparency” is tied to maintaining the information captured by Tax Administration available on the Web, to be queried by taxpayers as well as the State agencies that require it.

On the other hand, this transparency, in addition to relying on the ad-hoc technological applications, shall be regulated from the legal and regulatory standpoint, to ensure privacy and security of the information stored in the SII databases. This regulation shall make available to citizens the laws, rules, procedures and general administrative decisions with regards to e-Commerce.

By virtue of the above, transparency shall be present in two areas: facilitating the information available to the services’ beneficiaries and the competent authorities and in the audits performed by the Internal Revenue Service by diverse mechanisms.

An example of a tax control is the digital signature, which guarantees businesses and the SII that the invoices and other electronic tax documents are not tampered with or that the issuer is not replaced. The digital signature technology currently enables the exchange of electronic documents with the complete certainty of the users. The enactment of the Digital Signature Act has enabled the electronic invoice, as well as other acts and contracts signed by this mechanism, to be legally valid and have the same effect than paper documents, with the additional advantage of a reduction in the transaction cost and the guarantee of greater efficiency and productivity.

It is worth highlighting that the Internet applications of the Tax Administration constitute a national contribution to the modernization and transparency of the State, and internationally, they strongly contribute to the country's image.

3.2 Description of Mechanisms Implemented in the SII

E-Commerce has brought about a series of benefits by breaking a number of barriers present in traditional commerce, broadening the action borders among the parties to transactions, eliminating the transaction costs, reducing the geographic and temporal limitations, etc. This new form of operation and coordination by IT platforms, in turn, has brought about a series of challenges for the auditing entities of the tax administrations, to the extent this new form of operation entails a greater difficulty in the individualization of participants in the e-Commerce transactions, and in obtaining data relative to the transactions themselves (amounts, dates, types of assets and services exchanged, prices, domiciles of participants, etc.), critical information for the exercise of their auditing functions.

The foregoing makes the adoption of mechanisms to enable the transparency of such operations very important, by which the tax administrations have had to create, adopt and enhance a series of technological and legal procedures and mechanisms in order to not lag behind in this area.

On the one hand, such measures are aimed at facilitating taxpayers' compliance with tax obligations by providing more and better electronic services, and on the other, the adoption of measures to control such operations.
In this regards, the following initiatives may be highlighted.

3.2.1. Online Tax Cycle

The taxpayer has been offered the possibility of conducting formalities electronically for each one of the different stages of his economic activity, enhancing voluntary compliance.

This innovative vision was materialized with the 100% Internet Tax Compliance Cycle, which seeks to support the development of the economic activity and businesses, taking advantage of the similarity between the business cycle and taxpayers' tax compliance stages. Thus, the purpose is that the Online Tax Lifecycle supports and

empowers the business cycle, by achieving tax compliance that fosters productivity and efficiency improvements in its development.

Thus, we have made available the **On-line business activity authorization** to taxpayers**,** enabling them to notify the business start up via the Internet, without the need to visit the SII Units to complete such proceeding. Likewise, we have implemented the **Online Business Closure,** an option for the taxpayer to notify and file the Business Closure via the Internet, in addition to viewing the status of their applications and the Business Closure Certificate for their economic activity.

3.2.2. Third-Party Information E-Statement (Tax Statements)

Tax statements are forms that certain taxpayers are required to file with the SII with regards to income, exemptions, credits and others, obtained from the different types of taxpayers, and are aimed at comparing the information delivered by taxpayers via the respective forms for statements and tax payments. Approximately 50 types of statements exist, grouped according to:

- Income Tax Statement
- VAT Statement
- Stamp Tax Statement

3.2.3. Taxpayer ID Instruments

The taxpayer registry and the Secret Key are one of the instruments employed for taxpayers. The Secret Key is one of the instruments established for taxpayers to identify themselves on the SII Web site and conduct their formalities in the SII Virtual Office, privately and securely. On the other hand, taxpayers may employ digital certificates to operate in a secure and private manner on the SII Web site.

3.2.4. Filing and Paying Taxes Via the Internet

We have created services for taxpayers to file and pay via the Internet the annual Income Taxes, monthly taxes such as VAT and file their tax statements with mandatory information as required by the SII. Additionally, foreign investors may credit their taxes paid in Chile via the Internet.

Also, the SII makes available to taxpayers on its Web site a Draft Income Tax Statement. This innovation has implied a significant impact on the simplification of tax compliance and reduction of compliance costs.

3.2.5. Electronic Invoice

Its employment enables the tax validations of commercial transactions performed with electronic documents, resulting in a significant saving of resources with respect to printed documents.

In Chile, the Electronic Invoice generates a platform for e-Commerce, since it considers the use of the digital signature, provides legal validity to the electronic document and therefore, enhances the use of the Internet for commercial transactions in addition to enabling the B2B electronic integration (customer-business /vendor). Typically manual processes, largely inefficient and costly, are replaced to improve the efficiency of business cycles and increase productivity.

3.2.6. Mipyme Portal

The Mipyme Portal was created as a public-private alliance, and is part of a project that seeks to enhance business management of micro, small and medium-sized businesses (Mipyme, as per the Spanish acronym) such as their tax compliance, after determining that both aspects exist in harmony and are supplemental.

The Portal has enabled to contribute to a greater competitiveness of micro, small and medium-sized businesses by the use of Information and Communications Technologies (ICT), and the transfer of new management and technical capacities for Mipymes to benefit from ICT in favor of their tax and business management.

Other portal advantages:

- Subscription and use of the portal has facilitated a better insertion in the formal market, allowing access to credit, improving relations with creditors and enhancing their business.
- Reduction of costs throughout the administrative and tax process, for example, by the use of the electronic invoice.
- Active participation of the Mipyme in the Portal enables to strengthen the acceptance by the different trade associations.
- The Portal becomes the organizer of the Mipyme business administration, facilitating its transparency and enabling a greater value added to the work of the Accountant of the Mipyme.

- Consequently, a greater harmony is achieved between tax compliance and the development of the business.

3.2.7. Electronic Tickets' Invoice (BHE, as per the Spanish acronym)

The Electronic Tickets' Invoice produces the same legal and regulatory effects as a printed Tickets' invoice.

3.2.8. Other Relevant Services:

a) Payment of the Real Estate Contributions (BBRR, as per the Spanish acronym) via the Internet: enables the owners of Real Estate Property to pay off their taxes online. In addition, they may request the Real Estate Appraisal certificate.

b) Domestic sales and exports' electronic invoice:

c) Purchases and services' electronic invoice: paper authorization for cash registers.

d) Internet tax payment system. The system enables the payment of Income Taxes, Value Added Tax (VAT), real estate property taxes and payments assessed by the TA for tax differences and fines.

e) Online Certificate of Origin: it constitutes a requirement to be met pursuant to the free trade agreements with the European Union. This formality has been favored by the issuance of the Electronic Exports' Invoice.

3.3. Difficulties and Solutions

In the development of new electronic solutions and products that enhance their contribution to e-Commerce, the SII has been establishing through the years a series of historic landmarks, such as:

- 1995: implementation of the first SII Web page to disseminate information among taxpayers.
- 1997: Internet-based Income Tax statements are launched.
- 1999: Income Tax rectifications and payments, and VAT filing, rectification and payment may be performed via the Internet.
- 2001: Internet draft Income Statement enabled.
- 2003: the E-invoice initiative and the electronic ticket are launched; Internet business start up is enabled.

- 2006: the Internet business closure form is launched, as well s the electronic accounting function for businesses.

The successes of the Internal Revenue Service in this respect have been many, with international acknowledgement by a public services' technological innovation award of the UNO, in 2003.

In order to conduct such initiatives, the SII had to overcome a series of challenges to implement the electronic solutions mentioned above, which are summarized as follows:

3.3.1. Legal Aspects:

Until the year 2000, in Chile, the electronic signature and electronic documents lacked legal validity in a court of law. Prior to this Law, only printed documents were admitted as evidence in a court of law, which hindered the development of IT applications. The electronic signature also lacked legal validity.

Therefore, in the year 2001 the SII issued a resolution validating the Electronic Signature for tax formalities. Additionally, a law was passed enabling electronic documents to be deemed legally valid, presented in court cases, supplemented with the regulations on the electronic signature of documents.

3.3.2. Technological aspects:

Beginning in 1990, the SII implemented a deep change of its systems, by replacing the proprietary platforms with open solutions. This had a positive impact on all subsequent developments, since it was the basis to enable the subsequent initiative of the SII Web site (www.sii.cl) beginning in 1995.

3.3.2.1 Security:

The information that the taxpayer delivers via the Internet, as well as the information stored in the SII databases shall be protected from theft or tampering. For such purposes, we have applied technological barriers and procedures that protect the appropriate use, privacy and security of the data managed by the institution.

Procedures shall consider controlling the information access privileges by the officers and users of the systems, as well as measures and actions to be executed in case any system security violation occurs. In this respect, firewalls, encryption (extensively applied in the electronic ticket and invoice) are extremely relevant, as well as the creation of

separate environments for the development, testing and operation of the IT applications.

3.3.2.2 Integrity:
We addressed issue of the integrity of the information stored in the SII databases, that is to say, that information is not corrupted by tampering or uncontrolled handling. For such purpose, available technologies such as hard disk arrays, back-up policies, electronic libraries, protection against force majeure and alternative backup sites are implemented, among others.

3.3.3.3. Availability:
The value of the information or data stored or gathered by the SII applications is directly tied to the availability thereof, which requires systems to rely on appropriate reports or outputs, of the information available, within the terms required, which may range from seconds, in the case of onsite or online taxpayer assistance (via the Internet), or even hours, in the case of massive information crossing or data validation processes employed in generating lists for audits or refunds requested, when applicable.

3.3.2.4 Communications and networks:
At the time of initiating this process, the country was in the middle of a deep modernization of the telecommunications system overall, which favored the availability of networks with an adequate bandwidth. In this respect, it is worth remembering that the use of the Internet commercially for the general public in Chile started in 1997, and these pioneer efforts were more difficult to disseminate in the early days.

3.3.3 Cultural Aspects, Communication and Human Resources

3.3.3.1 Experience and knowledge:

Since it is a pioneer institution in this area, even worldwide, and considering the fact that it administrates a large volume of information and transactions, it was difficult to find skilled staff to perform the developments internally, as well as to provide support when we called for bids for an outsourced company to build them.

Even for electronic invoicing, at the time of its design no open technologies were available that would provide the security required and support the enormous number of transactions needed for its operations. The only experience available was that of the Virtual Private

Networks, which implied a large investment and were limited since they required end to tend connections among the parties exchanging sensitive information. The first electronic invoice and information exchange systems for businesses used this system, which owing to its high cost never became massive and was later replaced by other Internet-based technologies.

3.3.3.2 Social culture and practices of the TA officials:
Citizens were not used to using and, moreover, trusting the Internet with regards to important transactions such as their tax statements. Therefore, it was necessary to implement a communications and education policy to mitigate lack of confidence in the system, and which would disseminate the knowledge on the use of new technologies among citizens.

This also entailed a change in the procedures and forms of working of the Internal Revenue Service officials, calling for training and the commitment that these changes would entail an improvement in the working practices thereof, which effectively occurred and has enabled to sustain the pace of modernizations to the present.

3.3.3.3 .Dissemination and promotion:
Making the public and the government support these developments required the implementation of a dissemination and promotion policy that emphasized the advantages vis-à-vis costs and benefits of time, security and error reduction in the tax statements and SII audits.

3.3.3.4 State modernization:
This is the area featuring one of the main difficulties faced: harmonizing the development of these facilities by the SII, with the other institutions of the Chilean State (for example: the electronic signature and its use in a court of law).

3.4. Results Obtained from the Mechanisms Implemented

The application of the policies and strategies aimed at the extension of taxpayer assistance and services by electronic procedures (Internet) show a high-degree of acceptance and growth, as evidenced by the results described hereunder.

In the Income Operation 2007 process, over 2.2 million statements were filed, out of which 97% were filed via the Internet, one of the highest levels reached among the tax administrations of the world.

Likewise, the 1.5 million Draft Income Tax statements prepared for taxpayers based on the available information in the SII databases are worth highlighting. This accounts for 64% of the total statements filed and entails 12.3% growth with regards to 2006.

Vis-à-vis VAT statements and other monthly taxes, in 2007, 6.1 million statements were filed via the Internet, 12% more than in 2006, which accounted for the payment via the Internet of over US$16 billion, that is to say, 10.8% more than in 2006.

With regards to the challenge of incorporating businesses in the Electronic Invoice system, in 2007 we recorded a total 6.806 taxpayers issuers of Electronic Invoices (68% of which are Micro, Small and Medium-sized businesses - MIPYMES), a total 135% growth with regards to the amount recorded in 2006.

It is worth mentioning that the segment with the largest growth is the MIPYMES, with 185% growth with respect to the 2006 figure. Consequently, the number of electronic documents grew to a total 87.4 million in 2007, which accounts for 26% growth against 2006. Although the number of electronic documents issued by the MIPYMES corresponds to the smaller portion of the total, they featured strong growth in 2007, reflected with the 893% increase.

Along such lines, we also reported significant increases in the number of taxpayers using the available services for the issue of the Electronic Fees' Ticket, with a total 637 thousand taxpayers (58% of the total) in 2007 using the service and accounting for 30% with regards to the year 2006.

4. CONCLUSIONS AND FUTURE CHALLENGES

4.1 General Conclusions

In Chile, e-Commerce is a system granting legal validity to the exchange of electronic information on the different tax documents. This practice had added complexity in the Tax Administration's auditing function, generating new mechanisms for transparency in the capture of information generated by e-Commerce. Once the internal mechanisms and developments are implemented, improvements are obtained in the taxpayers' business processes as well as the auditing work and the delivery of services in the Internal Revenue Service.

On the other hand, the SII has developed a number of electronic applications ensuring transparency of information in its twofold role in this field: the availability to taxpayers and the relevant authorities of access to information, and maintaining transparency policies in the auditing and control tasks performed by the Tax Administration.

The e-Commerce transparency mechanisms require the support of a legal and regulatory basis that governs such interactions with taxpayers and the agencies requiring this type of information, such as, digital signature validation, special laws like the Electronic Signature and Digital Certificate and the Sales Invoice Executive Validity acts, among others.

With regards to audits, the SII receives the largest portion of the electronic documents from taxpayers' proper, which constitutes a large volume of information that enables to improve controls and reduce tax evasion.

In turn, taxpayers incorporating into the system enjoy significant direct savings in the overall process of invoicing, distribution and storage of documents, in addition to obtaining significant productivity and competitiveness improvements by the digital treatment of their tax documents in line with their accounting, vendor and customers' systems.

On the other hand, the Internal Revenue Service gains access to better sources of information, since the online transactional record is direct and reduces the risk of information loss or tampering.

The record of the electronic information generated in the different e-Commerce transactions, facilitates its administration. Therefore, a broad array of services are generated that may be easily processed and channeled to cover the requirement of government and private entities, nationally as well as internationally.

Transparency, as a fundamental attribute incorporated in the design of electronic products and services, has enabled to facilitate taxpayers' greater access to the information required for its full tax compliance, by simple and expeditious procedures; and also contributed in simplifying related formalities.

The Internal Revenue Service shall continue to promote and empower the intensive and extensive use of the facilities provided by e-

government, under a policy of maximum transparency, quality of service and respect for the laws in effect.

4.2. Future Challenges

In spite of the implementations performed to date that have enabled taxpayers-citizens as well as the SII to obtain benefits, further innovation is required, since the context in which the SII operates is ever-evolving and faces increasing demands. We may mention the following future challenges appearing in different areas:

4.2.1. Regulatory Sphere:

- Creation of a group of experts to study the impact and enforceability of regulatory proposals of international studies vis-à-vis Direct and Indirect Taxes.
- Compiling domestic regulations aimed at e-Commerce in a virtual assistance office.
- Amend penalties and powers in the Intellectual Property Act (sanctions for piracy and illegal trade).
- Lifting Bank Secrecy.
- Amendments for the use of the MiPyME tax system based on incentives.

4.2.2. Management

a) Taxpayer assistance:

- Implement a one-stop shopping system for government agencies.
- Disseminate the use of the Electronic Invoice (voluntary and mandatory compliance).

b) Training:

- Train auditors in digital auditing systems.
- Digital taxpayers' tax education programs.
- Reduce the digital gap.
- Increase connectivity.

c) Coordination:

- Coordination and gathering information with the NIC in Chile[6] in the allocation of domain names.
- Online efforts with Customs for the qualification of Exports' Services.

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[6] *NIC Chile: NIC is an acronym for "Network Information Center", the international name of the organization in charge of managing the domain names in any given Internet category.*

- Homologating databases with related Public Services (access to online operating information).
- Obtaining information from private agencies related to e-Commerce.
- Joint communication campaigns with SERNAC.

d) Information requests:
- Promote information exchange agreements with other tax administrations.
- Mutual cooperation agreements.
- Determine information-rendering obligations of a tax nature to e-Commerce intermediaries.
- Complete the electronic payment cycle with different levels of records (in Chile, cash payments are considered).
- Readjustment of online changes of domicile.

4.2.3. Taxation and Control Sphere:
- Multidisciplinary teams to conduct digital audits.
- Group of experts to apply Tax Intelligence to the risk entities entailing e-Commerce evasion.
- Coordinate with other State agencies joint preventive efforts of e-Commerce crimes.
- Execute e-Commerce auditing plans, payment of patents and services for the use of software.
- Control of the registry of e-Commerce operators’ domain.
- Strengthen mutual cooperation and auditing agreements with other tax administrations.

TOPIC 3

BUILDING, DEVELOPING AND APPLYING RISK MANAGEMENT

Lecture

Topic 3

BUILDING, DEVELOPING AND APPLYING RISK MANAGEMENT

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CONTENTS: Summary.- 1.Risk management in a tax administration.-1.1 Overview.- 1.2. The risk management paradigm.-1.3. Risk management process and methodology.- 1.4. Role of the internal audit body in risk management efforts.-1.5.Requirements for the implementation of the risk management process in a tax administration.- 1.6. Establishing a risk management process in a tax administration. - 2. AEAT risk map. - 2.1. background.- 2.2. Strategic decision.- 2.3. Risk map features.- 2.4. CPHASE one. risk analysis.- 2.5. Second phase. risk management.- 2.6. Third phase. execution of the measures- 3. Conclusions and Recommendations

SUMMARY

Section one addresses the benchmark model for the risk management process in an organization.

Risk assessment is inherent in the day-to-day activities of Tax Administrations, and international experiences in the development of risk management processes have increased. We shall refer to the CIAT Internal Audits' Manual and the Internal Audit Regulations' System, sponsored by the IDB and CIAT.

Risk management has become the internal control paradigm for organizations and lies in the heart of corporate governance. One of the titles includes the basic definitions and the framework of reference to manage risks, included in the COSO II Report.

Corporate risk management is a process conducted by the Board of Directors, Management and the rest of the staff, as part of the organizational strategy, designed to identify, assess, manage and

control potential events or situations, with the purpose of reasonably assuring the achievement of the organizational objectives.

In the Tax Administration, the process shall rely on a documented procedure, approved by a law of sufficient hierarchy.

In any case, risk management requires the selection and application of a methodology that supports the design of the integral risk management system and provides monitoring guidelines. The following constitute basic elements of a methodology: identifying the related processes and objectives, determining related risks, assessing inherent risk, identifying existing controls, weighting residual risk, determining the risk treatment and residual risk assessment measures after applying them.

A key risk management notion is the existence of a specialized internal control body that creates value by promoting, coordinating and monitoring the process.

The implementation of risk management in a Tax Administration is facilitated by requirements that contribute to the materialization thereof: an appropriate corporate culture; the availability and efficacy of the corporate systems tied to the strategy, planning and performance control; internal control system's effectiveness; information systems that embrace process controls; an information and communication policy.

This presentation reflects on the opportunity of establishing a formal risk management process based on the corporate ends pursued, the results to be achieved and the direct and opportunity costs. We conclude that risk management is an improvement, cohesion and transparency factor for the organization, with a scope measurable as a function of its cost.

Section two approaches the development of the Risk Map of the State Agency of Tax Administration (AEAT, as per the Spanish acronym) of Spain, and illustrates the foregoing notions.

The AEAT relies on a set of requirements to facilitate the task of addressing new risk management processes with sufficient grounds: an annual objectives' system; a specialized internal control body (Internal Audits'' Service); bodies that have been in charge of control, security and risks (Sectorial Security and Control Committees) since

1998; and an integrated corporate information system that automates procedures and incorporates controls.

The Steering Committee appreciated the maturity of the internal control system and the corporate culture, and approved a formal risk management process at the end of 2005, materialized in the development of the first AEAT Risk Map, as a supporting instrument for Management that serves to structure the activity of control bodies.

In order to implement the Map, we designed a methodology in line with the integral risk management benchmark framework set forth in the COSO II Report, endowed with specific instruments such as risk cards.

We have developed the Risk Map according to three phases: “risk analysis”, “risk management” and “monitoring treatment measures”. The three phases cover all the stages in a risk management process.

The first AEAT Risk Map has almost completed its lifecycle and the organization assessed it as positive vis-à-vis residual risk reduction and strengthening the internal control system. Therefore, it shall continue in a second experience that shall employ the knowledge and experience acquired.

Finally, the presentation concludes that risk management contributes in attaining the organizational objectives, strengthens the internal control system and disseminates a context of transparency, security and trust in the performance of the entity. Likewise, we recommend the implementation of a risk management process as a feasible project for a Tax Administration, with a view to extending its scope and sustaining its execution on an appropriate methodology.

1. RISK MANAGEMENT IN A TAX ADMINISTRATION

1.1. Overview

The Tax Administration is deployed through organizations with great structural complexity, which shall define and assess its strategy and plan its performance in the medium and long term based on appropriate instruments, with the purpose of reaching the objectives set forth, appropriately aligned with the corporate mission.

The all but simple task of ensuring the materialization of this general guideline depends on the organization's internal control system. The purpose of the organization's internal control system is to achieve the objectives with efficacy, efficiency, transparency, reliability and according to regulations.

For years, the most widely implemented control model in the public as well as private sector points out that internal control activities shall not be merely the task of full-time specialists, but be assumed continuously by the organization overall and its staff. Additionally, control bodies should be chiefly devoted to the supervision of the control applied in order to strengthen the system overall. The model also highlights the relevance of internal and external communication and the information employed for control efficacy and the key role of Management.

The foregoing outlook entailed a firm progress but immediately went into a crisis. In effect, the control and audits' resources of an organization, evidently limited, should be devoted solely to prevent, mitigate or eliminate the incidents that, based on their frequency or impact, are likely to cause material damage, hindering the achievement of the objectives pursued by the organization.

This fact has currently induced a change of paradigm as regards internal control, placing risk management, which had been included in the previous model, at the heart of the organizations' governance process.

The control reports drafted by national and international entities have thus moved towards an internal control model based on organizations' risk management.

Particularly, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) has developed an integrated risk management framework of reference, known commonly as ERM (Enterprise Risk Management) or **COSO II Report**, whose first English edition dates back to 2004. Large public and private organizations are implementing risk management systems like this one to a greater or lesser degree, supported by risk analysis and risk management methodologies.

Risk management is not foreign to a Tax Administration, since risk assessment is part of its day-to-day activity at the different levels of organizational responsibility: the strategic risk of not achieving the

collection objectives defined in the Government Budget, the risk tied to fraud and tax evasion with a complex issue that sometimes requires devoting the largest share of the organization's resources; collection risk should a debt to be incurred be collected in due time and manner; the technological risk of availability of taxpayer services rendered via the Internet Office, etc. The risk culture, and therefore, the culture of opportunities generated, at least implicitly, is present in the Tax Administrations.

Formal corporate risk management is neither per se a novelty. Numerous public organizations from different States, particularly in the tax sphere, have approached integral risk management processes, in certain cases with a record of accomplishments extending in time and very rooted in the institution, incorporating this approach in their day-to-day activity.

Although such processes are very specific since they are conditioned by internal and external intrinsic factors, inherent in each country, the Tax Administrations of numerous countries increasingly implement them, and the latter feature an increase in national and international experiences.

The Inter-American Center of Tax Administrations, as an international organization focused on the evolution of the Tax Administrations, has actively participated in the organizations' adoption of risk management.

As a result of such concern, we may mention the **Declaration on the importance of Internal Control and the role of the Internal Audit** and the **CIAT Manual on Internal Audits'**, drafted by a Working Group coordinated by CIAT and the State Agency of Tax Administration, which involved representatives of the Tax Administrations of Argentina, Bolivia, Brazil, Costa Rica, Chile, Spain, United States and the CIAT Executive Secretariat. The Manual was approved in Florianopolis in 2006 and enshrines risk management as one of the basic references of an organization's internal control model, and devotes a specific chapter thereto. The Declaration expressly mentions risk management as a determining internal control factor.

Likewise, the recently published Internal Control Regulations' System, sponsored by the Inter-American Development Bank and CIAT, also highlights risk management as a key element to establish a strong control system.

As regards formal risk management, a Tax Administration may be initiating the process, deploying and expanding it, or rather experiencing a subsequent moment with emphasis on process continuity, assessment and monitoring. This presentation seeks to be useful for any of the initial situations, but the reflections herein are especially focused on the start-up of such a process, and therefore, on revealing the nature of risk management and how a corporate risk management process is built.

1.2. The Risk Management Paradigm

A risk is the possibility that an event occurs and adversely affects the attainment of an organization's objectives. We measure risk in terms of its occurrence probability and impact (damage caused by the materialization of the risk), with the following generic formula:

RISK = PROBABILITY x IMPACT

A risk may be caused by a threat, a circumstance that potentially occurs and inflicts harm on the organization, or a weakness, a situation that contributes to the materialization of the threat or the greater impact thereof.

Risk shall be measured in general to ensure an appropriate approach. The measure of risk always presents considerable difficulty, choosing quantitative or qualitative scales, the latter being simpler.

Thus, for example, the probability of occurrence of a risk may be high (probable in the short-term), intermediate (possible in the medium or long term) or low (improbable). As regards the risk impact, it may affect business continuity (critical), have an effect on the objectives of the organization that may not be attained (high), reduce the operative capacity of the organization but not hinder the attainment of the objectives (medium), or not affect the objectives (low). The valuations assigned to probability and impact are normally laid out according to color scales.

Pursuant to the COSO II Report, corporate risk management is a process conducted by the Board of Directors, Management and the rest of the staff, as part of the organizational strategy, designed to identify, assess, manage and control potential events or situations, with the purpose of reasonably assuring the achievement of the organizational objectives.

A risk management system is made up by the following eight elements, required for its implementation and maintenance, which shall be defined and addressed briefly in this same title: internal context, definition of objectives, risk identification, risk assessment, response to risk assessment, control activities, information and communication, and monitoring.

a. Internal context

It refers to the organization's attitude and is particularly determined by the actions and attitude of Management as regards the importance of corporate risk management. The internal context is the basis for any risk management system, providing discipline and a structure thereto.

The following are critical internal context factors:
- The overall shared beliefs in the organization on the matter.
- The risk the entity is willing to accept in the "pursuit of value", that is to say, the attainment of objectives.
- Management monitoring.
- Integrity and ethical values of Management and the staff.
- Staff competence, knowledge and skills required to carry out the inherent mission.
- The organizational structure, which provides the framework to plan, execute, control and supervise activities.
- The allocation of authority and responsibilities in an organization.

b. Defining organizational objectives

The organizational objectives may be intrinsically complex, with numerous categories and overlaps. Establishing them appropriately constitutes a critical success factor for the entity and shall precede the identification of the events that prevent the attainment thereof.

In any case, an organization's objectives shall be attainable and measureable, qualitatively or quantitatively. For such purpose, they shall employ performance indicators and perception measures.

The objectives have different typologies. The strategic objectives are the highest-level ones. The remaining objectives are tied to the different entity activities, frequently classified into the following categories: operating objectives, information objectives, compliance objectives and asset or resource protection objectives. Management determines

the strategic objectives according to the mission and establishes the guidelines to determine and assign the remaining objectives.

An effective corporate risk management provides the basis to align the strategic objectives with the organizational mission. Risks are also directly tied to the procedures and processes of the organization, through which the latter reaches its objectives.

c. Events' identification

The events that negatively affect the achievement of the objectives entail a risk and those that bear a positive effect, opportunities. In general terms, risks may not be eliminated; therefore, they should be managed. This entails identifying, assessing and controlling them by prioritized actions.

In order to facilitate risk identification, we classify them according to categories. For example, we call them corporate when Management assesses them for their impact on the organization's activity, and operational if they shall be addressed by the business units.

Risks are of very different nature and may be attributed to internal as well as external factors. Risk analysis is facilitated by the systematic examination of risk factors: external (economic, environmental, political, social, technological) or internal (infrastructure, personal, processes, technology).

d. Risk assessment

Risk shall be assessed by the organization before and after establishing controls ("inherent risk" and "residual risk" respectively), considering their impact on the achievement of the objectives and their probability of occurrence. Inherent risk assessment enables Management to continue with the existing controls, whose cost may be relevant.
In practice, risk assessment techniques consist in a combination of qualitative and quantitative procedures (benchmarking, probabilistic models, non-probabilistic models, etc.). A quantitative measure of the risk impact is the percentage of objective attainment jeopardized by the occurrence of such risk.

The most refined assessment techniques consider scaling of the organizational objectives and other variables such as the risk exposure period and the number of times a risk situation arises. Nevertheless, in

the face of an organization's difficulty in assessing the different types of risk, simplified qualitative scales are normally used, especially in the first risk management cycles.

e. Response to risk

Management assesses the most appropriate response to risk considering the effects of the response on the risk probability and impact, the costs of the potential answers and the opportunities arising upon attaining the objectives set forth, based on the four categories hereunder:

- Avoid:
Cease to perform the risk-generating activities.
- Reduce:
Act in order to reduce the probability, the risk impact or both.
- Share:
Transfer a portion of the risk.
- Accept:
  Do not undertake any action affecting the probability or the impact.

Therefore, management selects the control action on the risk that places the residual risk within the risk tolerance established by the organization, called "accepted risk". Management also assumes responsibility over the corporate risks that might not have been suppressed.

Upon deciding the risk response, an implementation plan and an effectiveness-monitoring plan are likely to be implemented. During the monitoring phase, a residual risk assessment shall be conducted, since in general terms it is not zero.

f. Control activities

They are the policies (what to do) and the procedures (how to do it) required to ensure the implementation of the risk response. The internal control of the organization is aimed at preventing, mitigating or transferring the risk.

Control activities shall be established throughout the organization, at all levels and all the functions, and conveniently integrated into the risk responses.

In general terms, we recommend that controls be incorporated into the management processes with continuous monitoring, which rely on compliance indicators and are conceived and executed preventively, in the form of alerts, instead of simply being concurrent or reactive to risk.

g. Information and communication

The information employed by an organization shall be identified, captured and communicated in due time. An effective communication flows in all directions, inside and outside of the organization.

Internal communication shall effectively express the importance of good risk management, the objectives of the entity, the risk accepted, the common risk language and the staff roles and responsibilities. Overall, the whole organization shall rely on appropriate information on the risk management system. External communication shall be supported and enhanced by the express commitment of Management towards third-party communication.

h. Monitoring

Risk management shall be monitored to ensure its appropriate operation and the quality of the results obtained.

Monitoring consists in ongoing supervision activities, integrated into management activities, and assessments, whose scope and frequency depend on the efficacy of ongoing monitoring activities and may adopt the form of a self-assessment.

1.3. Risk Management Process and Methodology

All the areas and the staff in the organization shall manage risk. Sometimes, we may even designate “owners” of each relevant risk, units that become directly responsible of their management.

Within an organization, risk management is ideally performed by means of specific bodies on the matter, Risk Committees, as defined in technical literature, which serve to enhance and give the process visibility. Their functions may vary significantly: a meeting forum for the different divisions of the entity who own the risks, a body with decision-making capacity for process control and monitoring, a technical body in which specialists analyze and assess the risk, etc.

Nevertheless, Management assumes the obligation of endowing the organization with an institutional risk management policy.

If any organization conceives risk management as a corporate process to be designed, implemented, reviewed and assessed pursuant to certain guidelines, this shall especially apply to risk management in a Tax Administration.

The process shall be enhanced if it relies on a procedure, documented in a manual or similar instrument, which may be easily communicated to all the employees and address all the key methodological issues.

The need to formalize the administrative activities is a constant in the public sector of any country, by which the procedure employed to manage risk shall require, additionally, the approval of a number of instructions by the organization's Management, embodied in a law of sufficient hierarchy.

In any case, the risk management process requires selecting and applying a risk analysis and management methodology. The methodology supports the design of the integrated risk management system and provides monitoring guidelines.

Selecting a risk analysis and management methodology is a Management decision, which may require the assessment of experts and the units implied in the process.

Following are a set of aspects that a risk management methodology shall include:

- Identifying and quantifying the objectives to be attained by the organization.
- Identifying and quantifying the controls established by the organization.
- Employing a hierarchical classification of risk and the conditioning risk factors.
- Identifying and prioritizing risk according to the importance and the probability of occurrence.
- Identifying risk in all the processes of the entity, according to a general top to bottom approach.
- Weighting the importance and the probability of risk occurrence.
- Using IT supporting tools, solely for risk assessment purposes

and presentation of outcomes with standardized documents and graphic interfaces to facilitate comparison.

Risk management methodologies employ specific techniques for risk identification and assessment. The following are examples of the instruments employed by the risk management methodologies:

- **Risk Surveys:**

Managers and experts in the organization provide risk-related information from their area of business in a standardized survey.

- **Risk Workshop:**

The risks tied to one or several processes in the entity are identified and assessed in a risk workshop. A risk management expert heads the workshop, in which attendees play roles and participate in group activities: brainstorming, discussions and vote casts.

- **Risk Reports:**

A group of managers and experts draft a document analyzing and assessing the key organizational objectives and processes and the risk incident thereto.

- **Color Map:**

Organizational risks are presented on a list containing, among other attributes, the topic or area of discussion, the risk description and the probability and impact thereof, inherent as well as residual, employing standardized colors for hues that define risk intensity.

- **Risk Map:**

The main risks that affect the attainment of the organization's objectives are represented graphically, categorized according to their probability of occurrence and their impact on such objectives. Risk Maps incorporate a large volume of additional data, are based on files, and attached documents, retrievable electronically.

Within an organization, the Risk Map drafting process is materialized by the execution of a series of phases, with a structure that resembles the following one:

1. Defining, classifying and prioritizing the organization's objectives.
2. Identifying the key processes.
3. Identifying associated risks for each objective and/or key process related therewith.

4. Assessing inherent risks.
5. Identifying the controls established by the organization.
6. Assessing residual risk.
7. Risk treatment.

Finally, it is worth pointing out that the risk management process is not free from difficulties and sets forth a complex methodological consideration. Hereunder we present a number of the recurrent issues, pro memoria:

- Determining the most important temporal and functional context and the scope for risk management in the organization.
- Identifying and prioritizing risk by means of a systematic process and classifying it in line with records that ensure comparability.
- Considering the risk assessment methods and scales, including among other aspects, the selection of comparable magnitudes for the different case studies, and the accuracy and relevance of the assessments obtained.
- The use of IT tools to assist in the assessment and presentation of results or otherwise, with a more ambitious purpose, to frame and control the risk management process proper.

1.4. Role of The Internal Audit Body in Risk Management Efforts

Although risk management pertains to all the divisions of a Tax Administration and its staff overall, it may involve the specialized auditing and internal control bodies more directly, which are defined in this title as an Internal Audits' Body, whose commitment with the process is vital for its start-up and continuity.

The Internal Audits' Body in an organization is not the owner of the risks. It is worth clarifying that Management is responsible for the risk analysis and management process. Nevertheless, the Internal Audits' Body shall actively participate in all the process phases: promotion, implementation and monitoring.

At first, the Internal Audits' Body shall inform Management as regards the relevance of corporate risk management, setting forth the advantages entailed thereby, and promoting a risk management process in line with the organization's features.

Once Management adopts the decision to implement a risk management system, the Internal Audits' Body shall play a proactive role, contributing in the initial establishment of the system, and even, coordinating and guiding the process. The implementation may be phased-in.

The Internal Audits' Body shall ascertain that Management adopts all the decisions required for the process start-up. Particularly, the Internal Audits' Body shall make sure that the organization selects an appropriate risk management methodology, disseminating and explaining it to everyone by all the groups or individuals belonging to Management or involved in the execution thereof. In a risk analysis and risk management process, training the agents involved is a crucial success factor. The methodology shall cover different phases of the risk analysis, risk management process, and complete the appropriate presentation of outcomes.

The Internal Audits' Body shall make sure, additionally, that the procedure adopted is geared at the key objectives in a risk management process: risk identification and assessment, determining an acceptable risk level, establishing risk mitigation and control activities, monitoring to periodically re-assess risk and the efficacy of the controls in place, and regular information to Management on the outcomes of the risk management process.

Finally, the Internal Audits' Body shall monitor the process, securing the appropriate coordination of the responsibilities and activities of the different groups and individuals directly involved in the process, to avoid duplications and omissions in the control efforts. Particularly, the Internal Audits' Body shall verify the information contained in the model and analyze the deviations registered in the control indicators.

The Internal Audits' Body examines and assesses the efficacy of the risk management process from a global perspective, issuing the pertinent improvement recommendations for Management.

The Internal Audits' Body is entitled to use the outcomes obtained in the risk analysis and risk management processes as a planning instrument to design the programs in its annual performance plan.

Should the organization rely on divisions expressly dedicated to risk management, outside the Internal Audits' Body, they shall focus on

promotion and implementation tasks, leaving the monitoring function to the Internal Audits' Body.

In any case, with the activities enumerated herein, the Internal Audits' Body would be carrying out one of its inherent functions: value creation for the organization.
Risk management is conceived as an ongoing process, or at least, cyclical. Therefore, the role of the Internal Audits' Body may vary in time, and consequently, the human resources and the methods and techniques employed thereby shall be modified. The analysis and risk management cycle in an organization entails a greater initial difficulty, which is the reason why the allocation of time and resources, specifically by the Internal Audits' Body, shall be greater in the first cycles.

1.5. Requirements for The Implementation of The Risk Management Process in a Tax Admnistration

The implementation and deployment of a formal risk management model in a Tax Administration requires the organization to rely on a set of previous experiences that drive the process and contribute to the materialization thereof. For the sake of brevity, we shall enumerate some of the most relevant, which carry an unequivocal meaning in an international context:

- The presence of a corporate culture favorable to risk management, in line with the notions in the first item highlighted by the COSO II Report.

The organization's Management shall assume a fundamental responsibility in establishing and maintaining such culture.

- The availability and efficacy of the corporate systems that relate to the strategy, planning and performance control.

Quantification and allocation of the objectives and the existence of tools for ongoing monitoring entail an appropriate framework of action for risk analysis and risk management. If this is aligned with a Balanced Scorecard that describes and prioritizes the essential activities of the organization, and measures its performance, we shall rely on a solid ground to address the creation of a Risk Map.

- Effectiveness of the organization's internal control system.

The degree of automation reached by the control activities and its integration in the ordinary performance of the organization is critical for a better treatment of risk. All this entails, in addition, a good knowledge of the procedures and processes of the organization and its hierarchy. The internal control system of the organization shall be monitored by specialized auditing and internal controls' bodies.

- Existence of an information system that systematically includes process controls.

Information systems have been long designed to support organizations' business strategy. The development of information systems has improved the capacity to measure and monitor the performance of entities and submit the corporate analytical information. On the other hand, the organization's dependence on such systems generates new risks and poses the issue of the appropriate information quality.

- Defining an information and communication policy inside and outside of the organization.

The availability of reliable and timely information facilitates knowledge on the role and responsibilities of all the parties involved in the risk management process, specifically the Tax Administration employees.

1.6. Establishing a Risk Management Process in a Tax Administration

Although any Tax Administration may be involved explicitly or implicitly in the assessment and treatment of corporate risks to a certain extent, the question arises as to whether to establish formal risk management of equal or similar features to those set forth above in the organization.

The answer depends on multiple factors, internal as well as external to the organization, which we shall briefly list for clarification purposes as follows: corporate ends pursued by risk management, partial outcomes and direct and opportunity costs arising from this decision.

- **Ends**

As regards the ends, the main one would be the treatment of the most relevant corporate risks for the organization objectives, reducing them to an acceptable level. Thus, the organization shall allocate human

and material resources more efficiently and strengthen internal control system. As an additional element, the proactive and holistic

risk management philosophy tends to deploy all the available resources, particularly the staff in full.

The model also enables to improve and structure the organization's self-knowledge, fostering identification of objectives and systematization of the business processes essentially consisting in this case in tax and customs procedures. Therefore, the risk management policy may be perfectly included in the strategy of the organization, contributing to the improvement of the planning and assessment instruments available to Management, and even facilitating comparisons with other organizations.

The risk management process and the underlying methodology also channel towards the organization a structured technical knowledge, relatively innovative and not evident per se, which is directly applicable in the ordinary performance of the institution.

Another value added of the process is the articulation of the organization's specialized internal control bodies, focusing their control and auditing activities more specifically towards monitoring and supervising the risk management process and the most relevant issues for the organization. In a large number of organizations, as pointed out in one of the foregoing sections, such bodies are instrumental in building the risk management process.

The Tax Administration Management may additionally encounter in this paradigm a stable form of materializing the corporate decision-making process on aspects that are as controversial as the allocation of resources to the different activities undertaken.
In brief, and from an internal standpoint, risk management is an improvement and cohesion factor for the organization.

Likewise, risk management delves deep into the notion of transparency by endowing Management with structured information on the organization's status and the potential evolution thereof. In effect, the organization may explain with greater clarity to political and administrative authorities, and society in general, the measures adopted to enforce the tax system and collect taxes, assisting taxpayers and countering fraud, and moreover, the limitations of this activity according to the resources available.

Therefore, risk management is the ideal tool to improve the internal and external communication of the organization.

- **Results**

As regards the partial results expected, expectations shall be put into perspective. Firstly, because risk management is generally conducted in a pre-existing organization, with an inherent corporate culture, whose maturity in this type of activities is a conditioning factor throughout the process. The presence or lack of experience and

requirements as pointed out in the foregoing title is clearly a factor to take into consideration.

For example, a positive experience in the use of risk analysis by specialized internal control bodies to determine the internal audits' actions that will make up their annual performance plan.

The organization's Management shall decide on the risk management scope: the functional areas and the territorial units affected, the goals set forth for each phase, and the most appropriate execution pace according to the available resources assigned to this activity.

It seems recommendable that the risk management process be implemented gradually in an organization and with initial realistic objectives, by means of few but significant experiences that serve to strengthen the process and the methodology employed, which may be assessed relatively easily and whose scope of action increased in subsequent cycles.

Notwithstanding, we should not forget that risk management is approached as a global activity that involves the whole organization and shall naturally tend to become an ongoing process, whose long-term benefit shall be at least the reduction of the relevant risks and the strengthening of the internal control system.

- **Costs**

As regards the costs of the risk management process, in principle, it should not include the cost of the risk control measures approved during the process, measures whose implementation would be also decided in a context that is foreign to the specific risk management, but rather assessing the direct cost of a corporate project of this nature.

Nevertheless, the cost of the process shall be analyzed in the medium and long-term since to the initial design and deployment cost, we shall add the cost of ongoing maintenance and review.

Although the process requires the participation of risk management specialists who do not belong to the organization and the acquisition or creation of digital instruments in support of the methodology and the rendering of outcomes, it seems that the main cost of the process is the participation of the organization's staff, especially managers and qualified technicians with experience in the organization.

Such cost, chiefly an opportunity cost, seems recoverable, for example, by graduating the process scope and simplifying its methodology.

Overall, Management shall consider the different elements reflected herein, and eventually other pertinent factors, determining whether a risk management process shall be pursued in the organization and its scope.

2. AEAT RISK MAP

2.1. Background

The State Agency of Tax Administration, created in 1992, is an organization in charge of enforcing the tax and customs system in the Spanish territory.

The corporate culture of the Tax Agency facilitates the task of building a formal, cyclical or continuous risk management process. Following, we shall highlight four key elements as milestones and background, without detriment to other additional ones:

- AEAT use of an annual objectives' system, aligned with the organization's mission and strategy, digitized and made up by a battery of quantitative indicators distributed in different levels.

The objectives' system is used to target the organization's activity and support the performance control process conducted by the Department of Organization, Procedures and Institutional Relations. The objectives to be attained are assigned according to territory by a cascade process, extended to all the functional areas and are reviewed continuously. The knowledge accumulated over the years has contributed to a better reliability of the information.

- A specialized internal control body as part of the AEAT structure, named the Internal Audits' Service, in charge of supervising the organization's internal control system, by the systematic development of auditing and advisory procedures in the framework of an annual plan.

The Internal Auditing Service is in charge of improving the internal control system, whose most remarkable feature is the inclusion of controls in the organization's tax and customs procedures, and therefore general risk investigation; it has coordinated regular two-year security plans in recent years. The Internal Audits' Service has adopted the internal auditing model set forth by the COSO I and COSO II reports, spurring the development of a more formal risk management process.

- Activity of the Security and Control Committees since 1998.

The Tax Agency relies on a General Security and Control Committee and six Security and Control Sectorial Committees, created by Resolution of 01/26/1998 of the AEAT Chairman and with jurisdiction in different areas: Customs, Special Levies and Customs Surveillance; Tax Management, Tax IT; Financial and Tax Audits; Collection; and General Security and Economic Management.

The Committees are in charge of preparing and developing the security and control policies, as well as reviewing the procedures established. Among other functions, the Committees perform risk analysis and risk assessment of the services' performance, establishing general security guidelines, and drafting and implementing proposals to improve and strengthen the control system, detecting their weaknesses. The work of the Committees is coordinated by the Internal Audits' Service and has been tied from its creation to the adoption of measures to mitigate the intensity or occurrence of risk; therefore, they are the perfect context for the process to develop the AEAT Risk Map.

- The existence of an integrated corporate **information system** with information from different sources, which has enabled the organization to automate the tax and customs procedures, optimize the management of extensive and intensive fiscal control processes and increase staff productivity.

In the last few years, this effort has focused on the supply of interactive services via the Virtual Internet Office. The information system serves as a common language for the organization in which the processes'

controls are framed: mandatory or discretionary actions to be undertaken by the stakeholders in the course of the tax procedure, automated alerts, information access controls, etc.

This favorable risk management framework is strengthened by the direct influence of the business areas of a tax and customs nature competency of the AEAT, in which risk control, investigation and determination are key constituents.

2.2. Strategic Decision

The Tax Agency Board of Directors appreciated the maturity of the internal control established and the existence of an appropriate corporate culture. At the end of 2005, it approved the beginning of a formal risk analysis and risk management process, aligned with the most internationally disseminated and renowned paradigm in this field set forth in the COSO II Report, in agreement with the model set forth in the CIAT Internal Audits' Manual.

In the context of the organization's planning efforts, this strategic decision was framed in the AEAT 2006 System of Objectives and Commitments, pursuant to the following text.
"Contents: one of the fundamental elements in current management performance is risk management, which has become a key aspect of modern management systems.

Therefore, we shall review the current Agency's risk management procedures and design an integrated risk management system and the IT supporting tools required for the implementation thereof."

The risk analysis and risk management process was materialized with the development of the first AEAT Risk Map, which arises as a vital instrument in aid of Management with the following objectives:

- Endow the Agency's existing risk management instruments with a method and coordination.
- Focus the attention of the different control bodies and activities towards the risk management efforts of greatest relevance for the AEAT.

2.3. Risk Map Features

The project was channeled via the Tax Agency's Sectorial Security and Control Commissions, since they are specialized in risk management bodies and work from the experience they have gathered since 1998.

Management urged each Committee to make up a Risk Group, with standing Committee members and other qualified authorities and specialists, relying on the participation of representatives of the AEAT territorial jurisdiction. The Risk Groups have conducted their activity throughout different stages contributing to the creation of the Map. The Risk Groups' activity has been expedited by the experience and knowledge of their members in the area under examination.

Project coordination was left to the Internal Audits' Service, which defined the process methodology, designed the common outcome presentation instruments and consolidated such results for their assessment by the Steering Committee.

Following the recommendation set forth by Management, the methodology employed for this first Map has been purposely simplified, owing to the opportunity cost of implementing other types of more complex solutions and the will of not depending on specialists foreign to the organization.

The risk analysis and risk management process has been based on the previous identification and classification of the organization's objectives and processes, and the subsequent risk analysis affecting them. The agents that intervened in this process systematically employed AEAT strategic planning elements and outcomes.

In all the phases, the methodology designed was structured according to common instruments for the different Commissions and Groups, in the form of Risk Reports and Files that achieved the comparability of the products obtained from the Map. Such standardized instruments have not entailed in practice a restriction for the work of the Committees, which in some cases additionally developed specific tools of greater scope and accuracy.

Risk management methodologies tend to rely on supporting IT tools. The Tax Agency has worked according to its own methodology, and ad hoc screening, integration and tabulation processes have been developed for the data received from each Committee in the subsequent project phases.

The stages of the AEAT risk management process were the following:

1. Defining, classifying and prioritizing the organizations' objectives regardless of their category.

2. Identifying the processes and sub-processes executed by the AEAT that were instrumental in achieving each objective.

3. Identifying the risk associated to each one of the key processes and objectives.

4. Assessing the inherent risk, "risk based on lack of controls".

5. Identifying the controls already defined by the organization.

6. Assessment of residual risk, "risk remaining after controls".

7. Treatment of the risk: analysis of the residual risk effect and identification and assessment of treatment alternatives.

These stages have been effectively developed according to three consecutive phases that shall be set forth hereunder: the first relates to "risk analysis", the second "risk management" and the third "monitoring treatment measures".

2.4. Cphase One. Risk Analysis

- **Tasks performed by the Risk Groups and Committees.**

In the first semester of 2006, each Sectorial Committee, via the ad hoc Risk Group, conducted a risk analysis of greater incidence for the objectives and processes of the corresponding area of the organization. The tasks undertaken made the work of the Committees more dynamic, since although certain risks formed part of their annual working plan, other risks had never been subject to direct attention until that time. The Risk Group undertook the following tasks:

Firstly, the Group defined a relation of the objectives of the area of utmost relevance for the organization as a whole. For this purpose, the Risk Group had to consider the organization's mission, and among others, the following corporate documents: the Tax

Prevention Plan, the Strategic Agency Plan, the AEAT Central Services' Commitments, the Special Delegations and Large Taxpayers' Central Delegation Plan of Objectives and the Tax Control Plan.

Secondly, the Risk Group determined the key processes tied to each one of the objectives selected, considering that in order to meet an objective, the outcomes pursued by such processes shall be attained. This activity was supported by the catalogue of administrative procedures under the AEAT responsibility and the structured set of available applications in their information system.

Thirdly, a risk study is undertaken, analyzing the key processes developed by the AEAT, as mentioned. The Risk Group stated the most relevant risks in the attainment of the objectives selected.

Each one of these risks was assessed before and after considering the application of the controls already in place in the organization. Their aim was to mitigate their impact and their probability of occurrence. This double measurement of the previous inherent risk and the subsequent residual risk assesses the efficacy of the controls established by the organization.

We decided on a qualitative risk assessment, with scales that take a small number of values for the probability of occurrence (low, intermediate, high), as well as for the impact (high, intermediate, low). The resulting range of values for risk was low, intermediate, high and critical.

The probability should be estimated as low if the incidence of the event of risk was less than 5%, intermediate if the incidence ranged between 5% and 15%, and high when it exceeded 15%. The impact had to be reported as high if it seriously jeopardized the attainment of the objective, intermediate if it had an intermediate incidence on the attainment of the objective, and low if the incidence was low. The value of risk was normally considered null when the impact was low, with the purpose of disregarding the risk with an immaterial impact.

- **Extension of the Strategic Risks' Study.**

The partial Risk Maps drafted by the Committees contained the most relevant operating risks, whose responsible bodies are the AEAT Departments, pursuant to their inherent competencies.

Therefore, the Steering Committee agreed to extend the study conducted to the AEAT strategic risks, of a cross-sectional nature, exceeding the competencies of the Departments and the Sectorial Committees.

The Steering Committee proper decided to perform the function of "Risk Committee" for the strategic risks, a role performed by the Sectorial Committees for the respective operating risks. For practical reasons, the strategic risks' study was assigned to the AEAT Departments more directly affected by their occurrence, in the capacity of rapporteurs. With this caveat, the same methodology was employed for operating as well as strategic risks.

- **Presentation of Outcomes.**

The methodology was based on two common instruments, according to which the outcomes were presented: Objectives' Report and Risk Analysis File.

The Objectives' Report is an additional document describing the situation of one of the selected objectives and the key processes related therewith and determines the main risks that jeopardize their attainment.

A Risk Analysis Report was drafted for each one of these risks, a mandatory document in which the Risk Group had to record the results obtained. The File was encoded for its subsequent processing and structured according to blocks describing the objective affected by the risk, the key related process, the assessment of the inherent risk, the existing controls and the assessment of residual risk.

The probability of occurrence, the impact and the risk, inherent as well as residual, were assessed on the File with the previously described qualitative scales. The existing controls required indicating whether they were automated, manual or both, and whether they incorporated alerts or not, that is to say, whether they featured a preventive nature. Risk was classified according to a name convention made up by 12 categories, adapted to the inherent activity in a Public Agency in charge of revenue and customs issues: structural or institutional risk, tied to the economic-financial performance, real estate management, communications, legal compliance, management information, management processes, human resources, information systems, information security, external and strategic risk.

Overall, in the course of this first phase the Sectorial Committees examined 69 objectives, 125 related processes and 190 operating risks. In line with the assumptions, the inherent risk was assessed as critical or high in a large majority of these risks.

Operating risks featured a heterogeneous profile, as regards the risk typology, and the assessment granted by the Risk Groups and the control attributes in place. According to the Committees, this variability is chiefly attributable to the features of each one of the AEAT areas. The coordination of the risk management activity was not meant to eliminate the differences among the areas, but rather to keep them at a degree that would not hinder the subsequent outcome consolidations.

- **Functional Operating Risks.**

The risks of the Collection area referred to the careful and accurate completion of the collection formalities, for their impact on the expiration, limitations and formal validity of the formalities. The risks in the Financial and Tax Audits area referred to the coordination of the auditing procedure, specifically the activities tied to the combat of tax fraud. The risks of the Management area shared the common denominator of the efficacy and efficiency of the established controls, the use of quality information and the correct enforcement of the tax system. The risks of the Customs and Special Levies areas were related to the adaptation of the human and material media employed in the different control tasks.

- **Operating and Instrumental Risks.**

The risk of the Tax IT area was centered on the availability of information systems, the reliability of the information employed by the organization, the quality of the applications, the timeliness of the contents and the safety and sensibility of the information. In an organization that seeks to reach and remain at the leading edge of the new technologies in the Public Administration, the risk inherent in these activities is usually very high. The risks attached to the General Security and Economic Administration Committee referred to the adequacy and continuity of the budgetary and material resources employed by the organization, and the very diverse issues of the most important organizational asset, its staff (selection, training, administrative career, mobility, etc.).

Nevertheless, the selection of the same methodology to undertake the analysis tasks and rendering outcomes highlighted common traits in

the examination performed by the Committees, especially, the broad risk reduction after enforcing the already existing controls, evidences that the risk management initiatives deployed by the AEAT have generally produced positive effects.

Without detriment to the reduction of risk, we also observed the prevailing relevance of a large number of risks, even after considering the control processes to which the Tax Agency subjects them. This was no surprise, since the Committees were required to address the risks that could affect the organizational objectives in the present.

Another circumstance evidenced at the time of consolidating the information is that the assessment method, qualitative and with few tranches in the probability and impact scale, could create distortions. Nevertheless, in order to maintain the comparability of the outcomes and the reliance on simplicity, it was sustained throughout the whole Risk Map development process.

In certain Committees, the risk analysis activity was extended beyond the demands of the common methodology, deemed a pilot experience for a more in-depth risk management in the future.

- For example, the Sectorial Committee on Tax IT undertook a systematic approach to the issue of risk, establishing an extensive risk catalogue and developing micro-IT tools in support of the risk assessment tasks, which could be employed by the Group's experts to run simulations.

As regards strategic risks, the organization classified as such the most relevant risks relative to the institutional and regulatory framework and the management, collection and tax control model, incorporating the ones relative to the determination of key policies in matters relative to budget, information systems, human resources, communications and alliances with other organizations.

- **Approval of the AEAT Risk Map in the Analysis Phase.**

Once the different Sectorial Committees approved the applicable Risk Analysis Files, the Internal Audits' Service integrated the results obtained and submitted them to the consideration of the AEAT Steering Committee in a standardized format. We presented the first phase of the Risk Map in July of 2006.

Consequently, Management made the decision that ensured the continuity of the development of the first AEAT Risk Map, and the execution of the second phase of the Map, consisting in the determination of more appropriate measures to mitigate a more limited set of risks than those included in the first phase.

2.5. - Second Phase. Risk Management

- **Tasks conducted by the Risk Groups and the Committees.**

The risks under this second phase shall be selected by each Committee from the ones analyzed under the first phase, applying the following selection criteria:

- Relevance.
The objective affected by the risk shall be of greater relevance for the organization.
- Impact.
Residual risk, after applying the existing controls, shall be still noticeable.
- Feasibility.
The treatment of the risk shall be feasible, shall not entail an inordinate a cost on the human or material resources and shall not imply a risk of a greater magnitude.

The Committees completed this selection work for the risks studied in the following phase in the course of 2006. Overall, we identified **62 operating risks** with an approximate average of 10 risks per Committee.

Additionally, the Steering Committee selected **eight strategic risks,** all of them transcendental for the organization.

Probably owing to the general and similar relevance of the objectives the Risk Groups examined, the most widely used selection criterion was adopting the risk with the greatest residual value, detecting that residual risk is overall greater for the risks selected than for the risks studied initially.

For each one of the selected risks, the Risk Group determined a treatment, articulated according to one or several **specific measures**, whose application by the organization should serve to eliminate, or at least reduce risk to an acceptable value, affecting the impact, the

probability of occurrence or both components. The recommendation was that the number of measures should not exceed three per risk, with the purpose of facilitating the monitoring work.

The measures selected had to be feasible and executable in the short or medium term, with human and material resources and an opportunity cost that the organization could assume. Likewise, the organization should be able to verify effective compliance with the measures.

The Risk Group in each one of Sectorial Committees concluded the task in the first semester of 2007, with the same makeup as the previous analysis phase.

- **Presentation of Outcomes.**

The methodology was based on a common mandatory instrument, the Risk Treatment File, encoded for subsequent processing, in which the Risk Group had to submit the results obtained.

The File was made up by blocks repeated for each selected measure individually: description of the measure, advantages and setbacks, cost assessment, and detailed implementation plan, which explains who assumes responsibility over the execution of the action and who exercises control of its implementation and deployment, the territorial scope and the execution terms, as well as the controls set forth by the measures incorporated in the organization's internal control system.

The 121 measures, with an average two per risk, proposed to mitigate the operating risks are of a regulatory, procedural and operative nature, according to the cases.
It is worth observing that in practice, the overall measures in this first Risk Map initially span a central scope, with execution responsibility in the Departments or Security and Control Committees. Nevertheless, the majority requires the deployment in the different units of AEAT for an effective implementation, specifically in the territorial Delegations.

- **Approval of the AEAT Risk Map in the Management Phase.**

Once the different Sectorial Committees approved the applicable Risk Treatment Files, the Internal Audits' Service integrated the results obtained and submitted them to the consideration of the AEAT Steering Committee in a standardized format. We presented the second phase of the Risk Map in July of 2007.

Based on this presentation, the Steering Committee decided to execute the third phase of the Map, consisting in the effective application of the 121 measures contained in the treatment proposed for the operating risks selected by the Sectorial Committees.

The execution of the measures was commissioned to Management in the Departments involved, which also hold the Chair of the respective Sectorial Committees. Likewise, Management in the Departments was empowered to adopt original implementation characteristics, especially as regards terms.

2.6. - Third Phase. Execution Of The Measures

- **Tasks conducted by Risk Groups and Committees.**

The purpose of this phase, still underway, is to ensure the execution of the measures adopted by Management. The subsequent assessment of the overall risk management process shall be employed to launch the second AEAT Risk Map in 2008.

In this phase, the Sectorial Committees and the Risk Groups shall foster the execution of the measures and report their compliance. Just like in previous phases, the Internal Audits' Service coordinates the tasks, designing a follow-up and assessment process based on a common methodology.

We established a first period, concluding on January 31st of 2008, for the Sectorial Committees to systematically report on the degree of execution of the applicable measures and assess the remaining residual risk. Since a portion of the measures, those with a greater scope, would be executed only partially by that date, a second data-gathering initiative has been foreseen before the end of 2008.

- **Presentation of Outcomes.**

The methodology employed to follow-up the execution of the measures is based on a common mandatory instrument, the Risk Monitoring File, encoded for subsequent processing, in which the Risk Group had to submit the results obtained.

With the purpose of facilitating the work of the Committees, we have designed a model that incorporates the information of the two previous phases into a single document, structured according to three large information blocks.

The first block, referred to risk analysis, has been preprinted with the data rendered in the first development phase of the Map.

The second block, referred to risk management, consists in a preprinted section with an implementation plan of the measure and a second section, devoted to the enforcement of the measure, which the Risk Groups shall complete ex novo with the following information: modifications to the initial implementation plan; degree of execution of the measure (annulled, not initiated, partial execution or completed execution); activities developed during execution; outcomes obtained (improvements and inconveniences); and controls established by the measure (none, automated, manual or both).

The third and last block refer to risk assessment, assessing the inherent risk, the initial residual risk and the residual risk at the time of completion of the file, when the management measures have been applied partially or even completely. If a certain quantitative indicator supports the assessment process, the value of the indicator before and after the execution of the treatment measures shall be recorded.

The integration of the results obtained in each one of the Committees shows that on the data gathering date, 83% of the proposed measures had been implemented and 19% completed.

Moreover, we recorded an estimated 13% reduction of residual risk upon the enforcement of the measures, with quite a uniform distribution in the different Committees.

- **Assessment of the AEAT Risk Map.**

The Steering Committee have been informed of the outcomes of the execution of the measures, integrated by the Internal Audits' Service, with a positive assessment of the residual risk reduction.

Monitoring the measures also entails an aspect of the assessment of the risk management process.

- As regards operating risks, the risk management process has consolidated as part of the common organizational heritage.
- As regards strategic risk, although at the time this report was finished it was under evaluation, the intrinsic interest entailed by the identification of such risk and the organization's strategies to approach them in the medium and long term are worth highlighting.

Finally, and in agreement with the conclusion of the evaluation of the first Risk Map, the AEAT currently considers risk management as an ongoing activity of the organization, within its strategy.

In order to foster this activity, prior to the end of 2008, we shall undertake work to develop the second AEAT Risk Map.

The re-iteration of the risk analysis and risk management cycle shall be based on the knowledge acquired and the outcomes obtained in the first Risk Map, to determine the jurisdiction, scope and schedule that better adjust to this second experience and the modifications incorporated into the methodology employed, the regulatory instruments used and training initiatives for the staff involved.

3. CONCLUSIONS AND RECOMMENDATIONS

1. Risk management has become the internal control paradigm for organizations and is at the heart of corporate governance. Risk management relies on internationally renowned benchmark models.

2. In a Tax Administration, the implementation of a risk management process directly contributes in attaining the objectives of the organization and renders an external image of transparency, security and trust in the performance of the entity. Risk management assesses and strengthens the organization's internal control system.

3. A risk management process may be established in any organization, in order to graduate its scope to balance the corporate ends pursued, the outcomes to be obtained and the direct and opportunity costs.

4. Risk management consists in an articulated process involving the whole organization and requires a continuous approach, or at least cyclical. In a Tax Administration, the process shall rely on a documented procedure, approved by means of a law of sufficient hierarchy.

5. Risk management requires the selection and adjustment of a specific methodology that facilitates the role of the different agents and leads the entity to the goals pursued by implementing the process.

Case study

Topic 3.1

INFORMATION RELEVANT TO RISK MANAGEMENT

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CONTENTS: 1. Summary.-2. Introduction.- 3. The relevant risk management information.- 3.1. Information description.- 3.2. The use of information.- 3.2.1 Information vis-a-vis risk management of taxpayers in general – A number of case studies.- 3.2.2. The specific case of risk management for large taxpayers.- 4. Conclusions

1. SUMMARY

This presentation seeks to present information deemed relevant by the Portuguese Tax Administration in the field of tax compliance risk management.

This work is divided in two sections. The first one describes the relevant risk management information and the second one, explains the use of such information.

Thus, in the first part, we wish to present a systematized structure of the type of relevant risk management information, especially focusing on income taxes and Value Added Tax, identifying the key sources of information, the access means and the main hurdles in obtaining it.

In the second part, we wish to detail the way in which the relevant information in the risk management process is used, highlighting the importance of segmenting taxpayers and presenting certain cases vis-à-vis the risk in requests for VAT refunds, taxpayers compliance risks when they own assets out of proportion with the income filed and the risk associated with the economic operators, with an effective or fictitious economic activity, with the purpose of committing tax fraud.

At the end of the second part, we shall address the specific case of risk management for large taxpayers, and identify the relevant information in building rating scales that segment taxpayers and prioritize the cases, while showing its application in a risk coverage model.

2. INTRODUCTION

Information is the key link in the paradigm underlying the activity of modern organizations, which operate in an increasingly complex internal as well as external field, competitive and ever-evolving.

The relevant information for the tax administrations may be appreciated from several angles, depending on the purposes pursued. This presentation is centered on the outlook regarding risk management information for the tax control sphere.

Tax controls are conducted at two different, although supplementary, levels: administrative controls and effective controls.

Administrative controls are basically automated processes, aimed at observing the behavior of registered taxpayers by the verification of formal compliance and the consistency of their tax statements; on the other hand, effective controls are the in- depth review of taxpayers' acts, confirming the truthfulness of their statements, by the verification of the respective supporting and registration elements, which should be geared predominantly at very well-defined objectives and in which compliance risk is greater, considering the efficiency of human resources management and related opportunity costs.

The appropriate strategic and operational decision-making strategies in the tax control sphere that enables resource management efficiency and efficacy in fostering compliance and detecting tax evasion shall be based on risk management models with a process that necessarily demands a careful selection, treatment, and assessment of the available information.

A risk management model entails the capacity of employing information intelligently, adding value to the tax control process, enabling, overall, to determine the focus that should be placed on each taxpayer, that is to say, defining the appropriate forms of action to cover risks and the respective priorities.

The risk management process entails the development of the following stages:

a) Risk identification
b) Risk analysis
c) Risk assessment
d) Risk coverage
e) Process assessment

This presentation especially deals on the first stage in the risk management process, that is to say, relevant information for risk identification, considering diverse taxpayer segments, to the stages in the process relative to risk analysis and assessment, considering taxpayer specificities.

The tax administrations, just like many other organizations, shall consider the need of segmenting taxpayers and identifying the most relevant information for each segment, since they demand the development of differentiated risk coverage strategies and actions.

Firstly, we shall consider identifying the relevant information based on the differentiated segments, which we shall define as basic, and which call for differentiated approaches, with variable materiality according to each segment:

- Corporations
- Individuals
- Large taxpayers
- Compliant or non-compliant taxpayers, with predominantly fraudulent activities.

In effect, one of the most frequent errors of organizations consists in placing their focus among clients in general, not paying sufficient attention to the truly relevant clients, normally few in number, but the most profitable. In the tax sphere, earning income entails detecting unpaid taxes, by which the taxpayers' segmentation process shall constitute a key aspect in the risk management process.

The relevant information cases identified in the following sections cover the different areas mentioned before.

3. THE RELEVANT RISK MANAGEMENT INFORMATION

3.1 INFORMATION DESCRIPTION

i. Sources of information.

Owing to their authority, tax administrations rely on a significant amount of information arising from the compliance with the obligations to which taxpayers are subject in line with their statements, not always justifiable according to their direct income, but above all, preventively; this sometimes hurdles the selection and analysis process.

The obligation to render information, just as the obligation to file tax statements, carrying tax relevant documents, including the accounting records or balance sheets and the delivery of other information, stems from the law, and is geared at calculating the tax payable.[1]

In Portugal, we may assert that the most significant portion of the information arises from the obligation to file tax statement, as follows:

- Annual income tax statements (Individual and Corporate Income Tax)
- Monthly or quarterly expense statements (Value Added Tax)
- Income and withholdings that are not subject to special levies applied on withholding agents
- Rent paid or made available to non-resident taxpayers
- Simplified Business Information (IES, as per the Portuguese acronym) – basic annual information that is attached to the overall relevant information for tax purposes, for the registration and deposit of accounts (Ministry of Justice), to perform national statistics (National Statistics' Institute) and financial system statistics (Bank of Portugal).

There are many other filing obligations, of a more specific nature, which would not be relevant to enumerate. All this information, that we shall call "systematized", is mandatorily delivered via electronic media and is imported to a data warehouse in order to facilitate its use for risk management purposes.

Nevertheless, there is other relevant information that does not reach the Tax Administration, held by other public entities, and when required,

[1] *General Tax Act, Art. 31º, Nº 2.*

is obtained by means of specific requests and under the cooperation obligations of public entities[2], such as Social Security, Citizens' Registry, Notaries, aeronautical and maritime activities' management entities, among others.

ii. Information typologies.

Prior to moving on to a more detailed description, we should address and systematize the type of information deemed relevant by the Portuguese Tax Administration in general terms.

Knowing how to gather, analyze and use information intelligently is definitely a competitive advantage of current organizations, vital for them to survive and add value, for shareholders, as well as the State, such as the case of the tax administrations.

The information deemed relevant may be divided into five large groups: private equity information, information on the economic and financial activity, tax information, citizen information and law enforcement information.

In the first group, the private equity information enables to describe the social typology of taxpayers and the value of their net worth, normally personal and unattached to business activities, therefore, posing greater control difficulties, arising mostly from significant restrictions in the access to bank information, as we shall see hereunder.

In the second group, the economic and financial information relevant to taxpayers with a business activity is naturally relevant in determining the importance thereof, that is to say, the respective materiality translated into the capacity of generating tax payments, vital for the segmentation process and to define action strategies. It should be always remembered that the larger taxpayers are also the highest risk taxpayers.

In the third group, tax information constitutes the core of the relevant information for the assessment of the degree of compliance, that is to say, the credibility that arises from the tax obligations and their consistency with regards to the materiality indices. Tax information is classified according to two types: information arising from tax statements and control information.

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[2] *As set forth in Art. 49 of the Tax Code of Procedure and Process.*

The information arising from tax statements originates in taxpayers' obligation to file tax statements and is recorded in databases. Control information, produced by the Tax Administration, stems from the automated identification of irregularities (information crossing or consistency tests) and the outcome of audits.

Corporate information is essentially obtained from reports, which, nevertheless, require adequate screening, since a significant portion of them are normally inconsistent. It may also be gathered from the media or non-administrative entities with social or economic responsibilities.

Finally, there is information from administrative or law enforcement bodies, such as public security, criminal investigation authorities, economic activities, etc., gathered by the participation of such agencies in the operations performed under the scope of their functions.

In summary, we shall rely on:

<table>
<tr><td rowspan="7">Relevant information</td><td>Private equity</td><td colspan="3">• Corporate equity
• Real property ownership
• Personal property ownership
• Bank accounts</td></tr>
<tr><td>Economic and financial</td><td colspan="3">• Balance Sheet
• Financial statements
• Notes to the Balance Sheet and the Financial Statements
• Records of approval of accounts and income
• Legal certification of accounts</td></tr>
<tr><td rowspan="3">Tax</td><td>Tax statement obligation</td><td colspan="2">• Transaction filed
• Taxes paid
• Ancillary obligations</td></tr>
<tr><td rowspan="2">Control</td><td>Administrative</td><td>• Automated information crossing
• Ratios</td></tr>
<tr><td>Audits</td><td>• Voluntary compliance
• Corrections</td></tr>
<tr><td>From citizens</td><td colspan="3">Reports, press, non-administrative entities with social responsibility.</td></tr>
<tr><td>From administrative and law enforcement bodies</td><td colspan="3">Results from investigations, money laundering proceeds, etc.</td></tr>
</table>

iv. Hurdles in gathering information.

The greatest hurdle in gathering relevant information is bank secrecy, which may be only opened, except in the case of criminal probes, by an administrative decision that is duly grounded and authorized in

each case[3]. This procedure spans certain bureaucratic aspects that may be summarized as follows:

<table>
<tr><td rowspan="7">Depending upon administrative authorization[4]</td><td rowspan="2">Without prior taxpayer hearing</td><td colspan="2">When there are leads regarding tax crimes.</td></tr>
<tr><td colspan="2">In the case of specific events identified indicating fraudulent statements.</td></tr>
<tr><td rowspan="5">With prior taxpayer hearing</td><td rowspan="2">Legal proceedings apply only for the purpose of refunds</td><td>In case of failure to appear or questions regarding the supporting documentation to the accounting records of taxpayers subject to formal accounting procedures.</td></tr>
<tr><td>In case of failure to appear or questions regarding the supporting documentation that justify the enjoyment of tax benefits or privileged tax systems.</td></tr>
<tr><td rowspan="3">Legal proceedings apply only for the purpose of suspension</td><td>In case of denial of access to bank documents upon verifying the impossibility of directly auditing the taxable income.</td></tr>
<tr><td>In the case of denial of access to bank documents upon verifying the significant reduction in the income standards that enable to determine expressions of wealth.</td></tr>
<tr><td>In the case of denial of access to bank documents when it is necessary to determine the application of government exemptions.</td></tr>
<tr><td>Depending upon a court order</td><td colspan="3">Access to relevant bank information relative to family-members or third-parties with a special relation with the taxpayer.</td></tr>
</table>

Therefore, we may infer from the foregoing the impossibility of using this information for risk management purposes; since in order to achieve efficiency in this field, it would be necessary to rely on taxpayers' bank information on an automated basis, free from the bureaucratic hurdles stated, as is the case in different countries. As defined above, this is not legally possible in Portugal, which constitutes a significant restriction for risk management.

[3] *General Tax Act, Art. 63° -B*

[4] *From the Director-General of Revenue or the Director-General of Customs and the I.E.C.*

3.2 THE USE OF INFORMATION

3.2.1 Information vis-á-vis risk management of taxpayers in general – a number of case studies

Case Study 1 – Granting VAT refunds.

Requests for reimbursement of the Value Added Tax (VAT) lack a specific approach, since they are especially sensitive to fraud. For such purpose, relevant information was identified, which constitutes a risk matrix that determines the type of attention required by each request, which may range from top priority – external audit– to low priority – simple automated request allocation.

The relevant information for this purpose may be divided into six different types:

- Conditions of the business activity
- Form of business organization
- Nature of the activity
- Consistency in the values filed on the regular statement for the purposes of VAT
- Refund amount
- Behavior in the tax calculation

i. The following are deemed relevant as regards the **conditions of the business activity**:

   a) The first request for reimbursement of the business activity;
   b) Request for reimbursement after business closure;
   c) Request for reimbursement subsequently after the opening or re-opening of the business prior to a 12-month period.

ii. As regards the **form of business organization**, it is relevant if the request is made by a non-resident entity without a permanent establishment;

iii. As regards **the nature of the activity**, the activities deemed risky are relevant: a real estate agency with an exemption waiver, car dealerships, maintenance and repair of motor vehicles, wholesale trade, retail trade of IT and communication equipment;

iv. As regards the **consistency of the amounts filed,** the relevant information refers to:

a) Variations in the refund amount;
b) Significant growth of exempted transactions entitled to deductions;
c) First exempted transactions entitled to deductions;
d) Refunds that are not essentially generated by asset purchases;
e) High amounts in exempted transactions entitled to deductions.

v. As regards the **refund amount**, it is materiality relevant, deeming the amounts in excess of € 1 million as materially significant and subject to audits.

vi. The form of calculating taxes refers to the information tied to corrections in the previously requested tax refunds, refunds arising from statements from more than three fiscal years, etc.

All this information is gathered from the Tax Administration database and is identified automatically. It always requires a positive reply from the tax audit in order to make the effective payment, when the risk matrix requires previous information.

Case Study 2 – Control of expressions of wealth and other unwarranted property elements.

In this regards, the Tax Administration has especially focused on such expressions of wealth with inconsistent evidence with respect to the amounts filed by taxpayers on their Income Tax statements.

In this case, the relevant information refers to the following:

- Real estate property registries;
- Light passenger motor vehicles and motorcycle registries;
- Recreational vessels' property registries;
- Recreational aircraft property registries;
- Raw material grants and loans.

The objective consists in crossing the individual net worth information filed and determining whether there is a significant inconsistency

between the ownership of such property and the income filed, which, if verified, legally warrants an indirect audit of the taxable income[5].

The information relative to the control of the expressions of wealth is gathered upon specific request of the Tax Administration to the Motor Vehicle Registries (for light passenger vehicles and motorcycles), to the General Aeronautics Directorate (in the case of recreational aircraft) and the Coast Guard (in the case of recreational vessels). The remaining information required is available in databases, arising from the mandatory tax statements filed, such as the case of real estate property registries and the inputs from partners or shareholders.

Case Study 3 – Detection of potentially fraudulent economic operators.

As regards the detection of potentially fraudulent taxpayers, the Tax Administration uses information included in a software called "Anti-fraud File" (RAF, as per the Portuguese acronym), which is divided into three groups, based on its source:

- Eurocanet
- Cases investigated by the Tax Administration
- Risk matrix

The first source of information comes from the Eurocanet (European Carousel Network), a Belgium project originally, financed by the European Union, consisting of a database of intracommunitary transactions' information, police information and other agencies', of different non-standardized nature.

The second source stems from information gathered from the cases under investigation by the Tax Administration and may also be of different non-standardized nature.

The third source is the information that the Tax Administration deems relevant in detecting potentially fraudulent economic operators and is based on two types of information:

- information based on specific taxpayers' background,
- information based on the regular profile of fictitious operators.

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[5] *Pursuant to Art. 89º of the General Tax Act.*

As regards the information on **specific taxpayers' background**, the following type of information is deemed relevant:

a) operators with previously cancelled authorization;
b) operators with a common partner/manager of an operator whose authorization was cancelled;
c) operator whose partner/manager is a spouse of the partner/manager whose authorization was cancelled;
d) operator whose partner/manager is common with a tax delinquent operator;
e) operator with the same domicile as another operator whose authorization was cancelled.

As regards the information based on the **regular profile of fictitious operators**, the following type of information is deemed relevant:

a) operator authorized in a risk sector;
b) operator chartered as a sole-proprietorship with minimum capital;
c) operator with a non-resident partner/manager;
d) operator with a foreign partner/manager;
e) operator with a partner/manager that does not file a tax statement or who files a tax statement with income equal to or lower than the minimum national salary;
f) operator with a partner/manager younger than 22 or older than 70;
g) operator with the same domicile as other operators';
h) operator with the same domicile as the partner/manager's.

The following sectors of business are deemed especially risky:

a) computers and any other type of device, including parts, accessories and software, manufactured or modified for their use on computers or IT systems;
b) telephones and any other device including parts, accessories and software, manufactured or modified for their use on telephones or telecommunications;
c) motor vehicles;
d) waste and scrap.

This segment of operators that is the target for this type of information gathering is normally short-lived and chiefly constituted for the perpetration of fraud. Therefore, early detection is vital as well as

subsequent follow-through, a process aimed at covering risks that requires the support of the appropriate identification, analysis and assessment of such risks.

3.2.2 The specific case of risk management for large taxpayers

i. The notion of large taxpayer.

In Portugal, the classification of large taxpayer is attached to corporations with a business volume in excess of 75 million Euros[6] (M€). Out of all the corporations registered for tax purposes (approximately 373,000 in 2006), only 0.17% of the total (close to 635 corporations) have a business volume in excess of said amount and contributed with an overall 35.2% of the total Corporate Income Tax (CIT) self-assessed by corporations in the course of that year.

If we extend this category to businesses with a business volume in excess of €500,000, we shall find 62,886 corporations that contributed an overall €2.79 billion, that is to say, we shall see how this coincides with Pareto's Law, that is to say the 80/20 ratio, a minority group of shareholders, in this case 17%, paid the largest share of self-assessed CIT, in other words, 80%.

In such regards, large taxpayers, whatever the approach, shall constitute a segment with a special treatment, with objectives, strategies and specific actions, by virtue of the high concentration of revenue, and the subsequent associated risk, in order to secure the State's revenue stability.

ii. Taxpayer assistance description.

Taxpayer assistance shall be described pursuant to type and intensity.

Type of assistance is understood as the treatment according to the taxpayer risk profile, such as, performance of an audit, an internal analysis of the tax statement, verifying compliance with obligations, or simply, no action.

[6] *This amount accounts for the minimum business volume for nonfinancial businesses, although for certain business sectors the minimum amount is higher (€100 M and €125 M).*

Assistance intensity is understood as the time allocated to each taxpayer in the planning process (working days per official) based on the type of assistance defined.

Thus, the Tax Administration-taxpayer relation at a given time may range from a simple automated audit on the compliance of certain obligations, or the consistency of the tax statement, without requiring any direct contact, in this case, a minimum intensity; on the other hand, an extensive audit of their overall tax status may be required, which entails high intensity.

iii. Determining taxpayer assistance.

The process to determine the appropriate assistance for each taxpayer is integrated into a risk matrix, which automatically determines such assistance, in a first phase. In spite of this, in order to integrate a taxpayer into a risk matrix, such taxpayer shall be linked to certain behaviors, voluntary or concealed, detected by the Tax Administration in this case. Such behaviors shall be defined according to a risk classification that identifies the risk profile thereof. Several methods apply to such end, from a quantitative classification based on the number of exposures to certain irregularities or tax statement inconsistencies, to a more qualitative ranking that summarizes the expression of its materiality and trend towards noncompliance.

The most synthetic form of substantial expression of the risk tied to a certain materiality and trend towards noncompliance, which we call risk profile, shall be a rating. A rating shall express a given risk in the compliance with certain obligations of materiality for third parties. Currently, companies that are specialized in risk ratings for countries and corporations produce ratings, generally tied to financial information data.

The advantage of this type of synthetic classification is precisely the possibility of automatically including any taxpayer in a risk matrix that translates the type of risk coverage actions applicable. This classification, from the tax standpoint, shall simultaneously enable the following decisive factors in the tax risk management process:

- Taxpayers' segmentation
- Prioritizing actions

iv. The tax rating.

Similar to a financial rating, defined as an “opinion on the capacity and will of an entity of meeting, in due time and manner and in full, the financial obligations subject to a rating and indicating the probability of default (*PD*) on their financial obligations”[7], the tax rating shall simultaneously express two independent, although inseparable, realities in the description of the taxpayer: materiality and compliance.

Materiality refers to the taxpayer’s magnitude and economic importance, that is to say, the capacity to generate taxable business or income, thus being a measurement of accuracy.

Compliance refers to the form in which the taxpayer voluntarily meets his tax obligations, which is a measurement of credibility.

These two variables behave on an inversely proportional basis in defining the risk. In other words, the highest risk is attached to a taxpayer with a greater materiality and the lowest credibility.

Therefore, the tax rating[8] is an opinion based on economic, financial and tax information on a taxpayer’s taxpaying capacity and the likelihood of having consistently met such obligation, whose materiality-compliance relation may entail the following:

<table>
<tr><td rowspan="4">Materiality</td><td>+</td><td>Moderate risk</td><td>High risk</td></tr>
<tr><td>-</td><td>Low risk</td><td>Moderate risk</td></tr>
<tr><td rowspan="2"></td><td>+</td><td>-</td></tr>
<tr><td colspan="2">Compliance</td></tr>
</table>

It is worth noting that, regardless of the degree of credibility, the greater risk is always attached to large taxpayers, since any omission or inaccuracy in their tax statements is always subject to becoming a failure to pay the highly material tax.

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[7] *Definition by the Compañía Portuguesa de Rating, SA, the Portuguese Rating Company.*

[8] *This classification excludes all the net worth and corporate information as well as the information relative to administrative bodies or law enforcement agencies.*

v. The relevant tax rating information.

The information deemed relevant in building a tax rating is of an economic, financial and tax nature. It is worth highlighting that, even if excluded from this category, the classification of the taxpayer's economic activity sector is always underlying, according to the Portuguese Classification of Economic Activities (CAE, as per the Portuguese acronym, Amendment 2.1)[9].

Consequently, the decisions regarding taxpayers' risk management based on ratings shall always consider the classification of the sector in which the taxpayer conducts his business. In certain cases, even the segmentation must be performed, in principle, on the basis of such information, such as in the financial sector or equity ownership management corporations, whose business and accounting regulations differ significantly from others, and, thus, lack a mutual comparative assessment.

a) The relevant tax rating information for the classification of materiality.

Materiality refers to the taxpaying capacity as determined by a potential economic income (REP, as per the Portuguese acronym) calculated according to the following indices:

- Business volume
- Gross Value Added[10]
- Net asset
- Equity ownership

b) The relevant tax rating information for the specific classification of risk.

The specific risk relates to the adjustments' background of the potentially outstanding tax per working day/auditor conducted on each taxpayer.

The specific risk is determined by dividing the overall historic values of the adjustments performed on each company (potentially outstanding tax in Euros) by the number of days required to obtain them. Historic values are updated annually with the official currency devaluation ratios.

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9 *Passed by Regulatory Decree Nº 197/2003, dated August 27th.*

10 *Replaced by the banking or insurance products for the financial activity sector.*

c) The relevant tax rating information for the classification of voluntary compliance.

c1) Corporate Income Tax (CIT).

Voluntary compliance with CIT corresponds to the assessment of the tax efficiency in the accounting income and the revenue per monetary unit in sales;

The indices to assess CIT voluntary compliance are the following:

1	Sales' tax profitability (RFV, as per the Portuguese acronym)	Taxable income/Sales+Services
2	Tax efficiency and economic efficiency ratio (REFE, as per the Portuguese acronym)	Taxable income-Net income for the fiscal year /Net income for the fiscal year
3	CIT from sales	Assessed CIT+autonomous CIT /Sales

The relevant information for this category arises from:

- Sales
- Services
- Net income for the fiscal year
- Taxable income
- CIT for the fiscal year

The following is the explanation of the ratios contributing to this category:

- **Sales tax profitability (RFV, as per the Portuguese acronym)**

This ratio states the tax efficiency for a given level of activity, that is to say, it translates the taxable value for each monetary unit of sales. Low tax efficiency may entail tax evasion, caused by transfers of assets or services rendered that have not been accounted for or assessed, or the costs recorded that are not costs arising from the ordinary business activity.

- **Tax-economic efficiency ratio (REFE, as per the Portuguese acronym).**

It corresponds to the difference between the revenue per every unit sold, that is to say, the tax efficiency, and the accounting

income, which also translates the income earned per every unit sold, or in other words, the economic efficiency, measured as a percentage of the fiscal year's accounting income.

The difference between the taxable income and the accounting income arises from the non-accounting tax adjustments, measured with regards to the pre-established amount, in this case, the same accounting income for the fiscal year.

- **CIT for sales (IRCV, as per the Portuguese acronym).**

This corresponds to the CIT paid per every unit sold. It differs from the tax profitability of sales because this ratio considers the eventual tax losses and benefits reports applicable. That is to say, a company may feature high tax efficiency, but have a zero CIT for sales owing to the absence of an assessed CIT for sales or autonomous taxation.

c2) Classification of VAT voluntary compliance.

Voluntary compliance with VAT corresponds to the tax efficiency assessment in the current domestic market transactions and the Gross Value Added in the domestic market.

The following are the indices for the assessment of voluntary tax compliance with VAT:

1	VAT payment level in the taxable transactions (NEIOS, as per the Portuguese acronym)
2	VAT paid - Gross Value Added ratio (RIVAB, as per the Portuguese acronym)

The following is the relevant information for this category:

- Assessed VAT
- VAT deduction
- Tax bases in taxable transactions
- Overall tax base
- Gross Value Added

The ratios contributing to this category may be defined as follows:

▪ **VAT payment level in the taxable transactions (NEIOS, as per the Portuguese acronym).**

This ratio gives us the relation between the VAT payment to the State and the taxable and non-exempted tax bases.

$$NEIOS = \frac{D - (E \times C/A)}{C}$$

VAT payment[11] to the State arises from the difference between the assessed VAT **(D)** from the transfers of assets and the rendering of services subject to tax (this does not include VAT assessed from intracommunitary acquisitions of assets and assimilated transactions) and deducted VAT **(E)**, discounting the VAT deducted from fixed assets from the surplus filed the previous fiscal year and the adjustments in favor of the taxpayer rendered by the services, deducted VAT calculated based on the ratio between the tax bases of the transactions subject to tax **(C)** and the overall tax base **(A)**.

The tax bases of the transactions subject to tax **(C)** correspond to the value of the transfer of assets and the rendering of services by a taxpayer with the tax assessed according to a lower, intermediate and regular tax rate (this does not include VAT assessed from intracommunitary acquisitions of assets and assimilated transactions).

The overall tax base **(A)** corresponds to the sum of the tax bases of the transactions subject to taxes and the tax bases of exempted transactions (this does not include VAT assessed from intracommunitary acquisitions of assets and related transactions).

This ratio is aimed at discounting VAT deducted from the inputs that correspond to the exempted outputs on a pro rata basis (intracommunitary transfers of assets and assimilated transactions)[11].

[11] *Transactions foreseen in item b), Section 1, Article 20 of the VAT Code and transactions that do not entitle deductions.*

Thus, a relation is established between the VAT payment to the State and the transfers of assets and rendering of services subject to tax, related to the current taxpayer activity in the domestic market.

This ratio calculates a tax payment level that reflects the tax efficiency of the value added by the company vis-à-vis the transactions (acquisitions of assets or services and transfers of assets or rendering of services) performed in the domestic market, without considering the transactions (acquisitions of assets or services and transfers of assets or rendering of services) with the external market.

Low tax efficiency could result in tax evasion caused by transfers of assets or rendering of services subject to taxation and not recorded or lacking an assessed tax.

- **Paid VAT - Grows Value Added Ratio (RIVAB, as per the Portuguese acronym).**

The ratio shows a relation between VAT paid to the State and the pro rata gross value added for the transactions performed in the domestic market.

$$\textbf{RIVAB} = \frac{\textbf{D} - (\textbf{E} \times \textbf{C/A})}{\textbf{VAB} \times \textbf{C/A}}$$

VAT paid to the State stems from the difference between the assessed VAT **(D)** from transfers of assets and rendering of services subject to taxation (this does not include VAT assessed from intracommunitary acquisitions of assets and assimilated transactions) and the deducted VAT **(E)**, discounting the deducted VAT relative to fixed assets, from the surplus reportable from the previous fiscal year and the adjustments in favor of the taxpayer reported by the services, the deducted VAT being calculated according to the relation between the tax bases of the transactions subject to taxes **(C)** and the overall tax base **(A)**.

The GVA is calculated by adding sales, work for the company proper, production variations, subsidies for productive activities, and additional income deducted from intermediate consumption (sum of the cost of inventory sold and consumed, outsourcing, supplies and external services and indirect taxes).

GVA is calculated with a ratio that determines the pro rata share for the transactions performed in the domestic market for it to be comparable with the denominator made up by the VAT paid to the State due only from domestic market transactions.

vi. Building the tax rating.

Different from a financial rating, which qualifies the creditworthiness in absolute terms, that is to say, regardless of the creditworthiness of the remaining market players, a tax rating shall indicate risk in relative terms, in order to enable taxpayer segmentation and the assessment of priorities in terms of assistance.

Financial ratings are built based on the use of linear regression and discriminating analysis techniques, considering attributes of different nature, some of them objective, such as the size of the business, the debt ratio, market share, macroeconomic conditions, or other more subjective ones, such as political risk, the profile of administrators or the technology employed.

The creation of a tax rating for the purpose of risk management of large taxpayers is not based on these techniques, but only employs objective features using a form of indexation based on 100 for all taxpayers, 100 representing the maximum absolute value presented by a business for such index.

This process enables a double objective in terms of risk management, as mentioned already – it segments taxpayers and ranks priorities, according to the following calculation:

a. Reference indices correspond to a single fiscal year;
b. The maximum value from the overall set of businesses is determined for each index, which is assigned a base rating of 100;
c. For the remaining businesses, it becomes the value of the index for an indexed punctuation at the value of the first rated one in such index (base=100);
d. The average rating for each business is calculated for the overall set of indices considered for each rating;
e. All the businesses are organized in declining order per each classification and divided into intervals according to the number of items that make up the rating.

For example, as regards voluntary compliance with CIT:

Taxpayer	RFV Benchmark: 10.66%=100		REFEE Benchmark: 3.60%=100		IRCV Benchmark: 2.22%=100		*Average Score*	*CVIRC Rating classification*
	Ratio	Score	Ratio	Score	Ratio	Score		
Ax	8.14	76.36	1.37	38.06	1.89	85.14	66.52	3
…….								
By	4.72	44.28	2.44	67.78	0.44	19.82	43.96	2
Cw	6.35	59.57	0.75	20.83	1.01	45.50	41.97	2
…….								
Tk	0.47	4.41	2.14	59.44	0.17	7.66	23.84	1

Classification 3 is the best in terms of compliance (higher credibility) and classification 1 is the worst (lower credibility), thus being a relative standing of each taxpayer as regards the remaining comparable ones (priority ranking).

An exception to this method is the determination of non-indexed specific risk, assigning the classification by value intervals (in monetary units €) of historic corrections by day of work devoted to such taxpayer in the past.

vii. Interpretation of the tax rating.

Financial ratings employ naming conventions generally starting on one letter, the **AAA** combination describing a financially compliant entity, and **D** describes an entity that is in bankruptcy, modifiable by a plus (+) or minus (-) sign to point out relative positions within the main risk categories.

In fiscal terms, it intends to rate a taxpayer as regards risk, the rating starting with an **A** being a potentially high revenue source and **D,** a potentially low revenue source. These features shall be tied to others, in this case, specifically, having previous tax violations and the level of voluntary tax compliance with income tax and value added tax, the materially more relevant taxes in this taxpayer segment.

As mentioned already, the tax risk is higher when tied to features that reveal high materiality, such as the business volume, GVA, net assets or equity ownership, to features that evidence low credibility, such as in cases of high levels of adjustments in previous audits or insufficient tax efficiency ratios.

The tax rating qualifications for large business are based on the following:

A, B, C, D

A indicates a highly profitable entity, with a potential capacity for paying high taxes; a **B, C and D** rating means a potentially lower economic yield in the future, and consequently, lower taxpaying capacity.

++, +, +/-, -

++ indicates an entity with a background of irregularities detected by the TA of high materiality, in other words, a very high specific risk; a **+, +/-** and **–** rating implies a background of irregularities of lower materiality in the future.

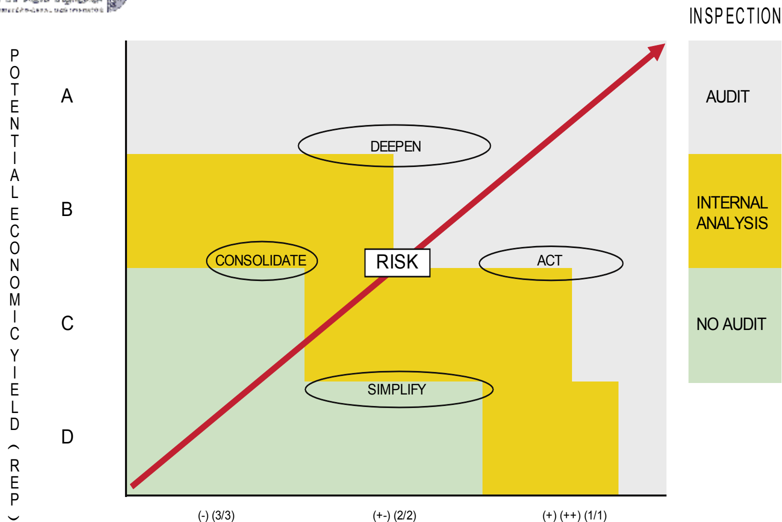
1, 2, 3

1 indicates an entity with voluntary tax compliance relative to a specific tax that is less reliable, if compared with the rest of the businesses; if rated 2 or 3, this entails greater voluntary compliance credibility in the future, when compared with the rest of the business.

viii. The use of the tax rating for risk coverage purposes.

For example, a business with an **A++1/1** rating is classified with a higher tax risk, owing to its high revenue generating potential (high economic yield – A), and features a very high (++) background of irregularities detected by the Tax Administration and its credibility is the lowest among the target businesses in terms of voluntary compliance with CIT and VAT, respectively (1 CIT/ 1 VAT).

Its status in terms of risk matrix, deemed as the planning of audits for large businesses, stands in the upper high quadrant of the matrix, which corresponds to an audit-type of assistance, arising from the qualitative reading of the cross-section between **acting** and **deepening** taxpayer knowledge.



4. CONCLUSIONS

The Tax Administrations shall employ information in a risk management context, that is to say, obtain, analyze and assess the information in such a way that it enables to make effective decisions vis-à-vis risk coverage and an efficient management of human resources.

The information stems from three differentiated levels: voluntary tax compliance stemming from tax obligations' compliance, information obtained directly by the Tax Administration enforcement power or obtained via third-parties in the sphere of the legal cooperation duties and by their own initiative.

The greatest limitation faced by Portugal in obtaining information in the risk management process arises from the impossibility of relying on automated taxpayers' banking information.

The information gathering process shall consider the different taxpayer segments. Segmentation is a key aspect in the risk management process, since the different taxpayers' features demand a differentiated approach, with three large groups calling for a very general approach: large taxpayers, operators featuring signs of fraud and the remaining taxpayers in general, individuals and corporations.

Beyond the information marking tax compliance risk in general, it is also essential to identify specific information, so as to enable the assessment of more specific risks, such as authorizing tax refunds, the consistency between the expressions of wealth and the income filed or the identification of potential fraudulent practices, among others.

The information characterizing large taxpayers shall be translated into an index that enables to synthetically show their risk profile, which, at the same time enables segmenting and prioritizing for the purposes of planning, adopting the rating classification.

Case study

Topic 3.1

BUILDING, MODELING AND APPLYING RISK MANAGEMENT

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(Uruguay)

CONTENTS: *1. Overview.- 2. Information relevant to risk management.- 2.1. Key benchmark elements and definitions in a risk management model.- 2.2. Specific treatment in the Uruguayan Tax Administration.- 2.2.1. Current scenario.- 3. Powers, sources and information systems of the general revenue directorate of Uruguay (DGI).- 3.1. DGI Powers.- 3.2. Sources of information.- 3.3. Data and information systems.- 4. Recent risk management case.- 4.1. Definition of the objective.- 4.2. Objective-related processes and inherent risks.- 4.3. Risk management actions.- 4.4. Management outcomes.- 5. Conclusions*

1. OVERVIEW

The first part elaborates on the key benchmark elements and definitions in a risk management model in an organization and its specific treatment in the General Revenue Directorate of Uruguay (DGI, as per the Spanish acronym).

Risk management has become organizations' internal control paradigm.

Corporate risk management is a process undertaken by the Directors, management and the rest of the staff, integrated into the organizational strategy, designed to identify, assess, manage and control potential events or situations, in order to provide reasonable assurance with regards to the attainment of objectives.

The second part explains the powers of the DGI to gather the information required to perform risk management. We set forth the different information sources and systems employed in the analysis. Likewise, we describe a set of requirements facilitating the task of

pursuing new management projects: an annual objectives system, an internal control body, associations in charge of controlling security and risk (committees) and a corporate information system under extensive development.

Finally, the paper concludes with the risk management treatment vis-à-vis taxpayer assistance in Uruguay after the implementation of the new tax system, describing the method employed in analyzing and solving the risks facing the Tax Administration. (CASE STUDY).

2. INFORMATION RELEVANT TO RISK MANAGEMENT

2.1. Key benchmark elements and definitions in a risk management model

Risk may be defined as the exposure to the possibility of occurrence of certain events that may have an effect on the organization's objectives. The notion of risk includes two elements:

- the probability that something occurs and
- the consequences should it occur

Risk exists by the so-called risk-factors. These are variables that shall feature a future behavior we are unable to predict with certainty, by which they are usually called random variables. This future behavior is what generates the risk.

Risks may arise from internal as well as external sources. Risk may cause problems with the organizational culture, failures in the IT systems, failures in the administration of human and financial resources, failures in taxpayers' control, deficiencies in internal controls, etc. The list could be endless. Even when it is impossible to rely on a totally risk-free environment, it is possible to avoid, mitigate, eliminate or transfer certain risks.

Risk management or administration is a formal process, systematically applying management policies, procedures and practices to identify, analyze, assess, prioritize and treat risks. It is a logical and systematic process that may be employed in decision-making to enhance effectiveness and efficiency. It constitutes a means towards an end.

Overall, risk management entails trying to identify and being prepared for what may occur. Taking actions to prevent, avoid or reduce costs

and other effects tied to the occurrence of certain events, instead of reacting after they occur.

Senior Management determines the strategic objectives in agreement with the mission and establishes a basis to determine the operating information and compliance objectives.
An effective organizational risk management provides the grounds to align the strategic objectives with the mission and to ensure they agree with the risk accepted by management.

We shall identify the events that may affect the achievement of objectives. Some may have a negative effect and therefore, entail risk and others have a positive effect, and thus entail opportunities.

Risk may be classified differently. A possible classification is based on the level of the organization they affect:

- Corporate risks: they shall be assessed by Senior Management, owing to their potential impact on the organization overall.
- Operating risks: they affect a lower level of the organization and shall be addressed at that level.

We may also classify them according to the factors they limit. Should such factors be external to the organization, the following applies:

- Economic risk
- Environmental risk
- Political risk
- Social risk
- Technological risk

Should such factors be internal, risk may be classified as follows:

- Human resources
- Senior Management
- IT
- Operating processes
- Infrastructure

Upon managing risk we shall find the exact balance between costs and benefits. It is utopia and not cost-effective to think in terms of a risk-free environment. What we must do is to determine the acceptable level of risk. In certain cases, the cost of the measures to avoid or

minimize risks at an acceptable level may be very high with regards to the benefits obtained. In other cases, the nature of the risk may entail that the acceptable risk level shall be null or extremely low. Overall, our acceptable risk level shall attain the objectives effectively and efficiently.

Measuring risk entails measuring the effect of the occurrence of the event affected by its probability of occurrence. In order to perform this assessment we shall assess:

- Inherent risk, which we define as the risk existing before establishing controls, and
- Residual risk, which is the level of risk remaining after taking the control measures to mitigate risk.

Comparing both enables the organization's management to assess whether to maintain the existing control, which may have a high direct or opportunity cost. When the residual risk continues unacceptably high, it is likely to be subject to subsequent provisions. Risks that compete amongst themselves shall be assessed and prioritized to take subsequent measures.

Diverse methods are used to measure the impact of risk on the organization, the most widely employed are: the intuitive approach, the regression model and the simulation model.
Management shall assess the organization's response to risk according to the following categories:

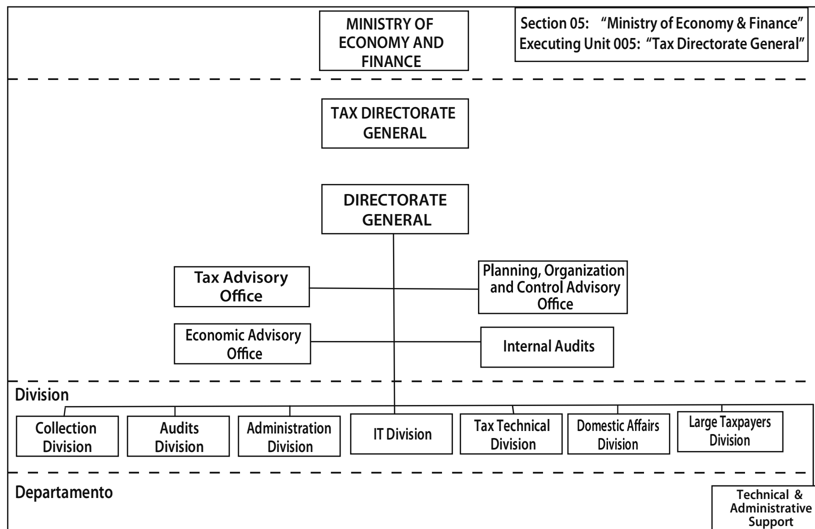
- Avoid: leave the risk-generating activities.
- Reduce: take action to reduce the probability of occurrence, the risk impact or both.
- Share: assign or transfer a portion of the risk.
- Accept: not undertake actions that affect the probability or impact.

The tax administrations shall be prepared to review and question the traditional forms of administration, with the purpose of determining whether there are new approaches and valid tools to use. The alternative to risk management or administration is the risky administration, that is to say, making decisions that are not based on a careful consideration of the events and risk involved.

2.2. Specific treatment in the Uruguayan Tax Administration

The organizational structure of the DGI of Uruguay is defined in Decree Nº 166/005 of May 30th, 2005, that governs Act Nº 17.706, which introduced modifications in the DGI organizational structure: creation of the position of Deputy Director of the DGI, Internal Auditor and the Large Taxpayers' Division. On the other hand, Decree Nº 192/006 of June 27th, 2006 updates the Tax Administration organizational structure and incorporates the modifications introduced by said Decree Nº 166/005.

Thus, the organizational chart of the DGI looks as follows:



As it may be observed on the Organizational Chart, the first level of the organizational structure is made up by the General Directorate, with seven reporting Divisions: Collections, Audits, Administration, IT, Technical Tax Procedure, Domestic Affairs and Large Taxpayers.

Three Advisory Offices also report to the General Directorate (Tax, Economic and Organizational Planning and Control), the Internal Audits department and the Administrative Technical Support Department.

The criterion of departmentalization is predominantly functional except in the Large Taxpayers' Division (which is structured by group of customers) and in the Domestic Division (territorial criterion).

According to the foregoing Tax Administration processes, the substantial functions are assigned to the Collections, Audits, Technical Tax Procedure, Domestic Affairs and Large Taxpayers' Divisions.

The supporting functions required for the effective and efficient performance of the substantial functions are fundamentally assigned to the Administration and IT Divisions with regards to human, material and technological resources' management.

The General Directorate is responsible of attaining all the organizational objectives, defining applicable policies, standards and guidelines for the performance of the different services.

The Internal Audits' area is in charge of controlling the appropriate application of the procedures, controls and other aspects, conducting audits as necessary.

2.2.1. Current Scenario

The General Revenue Directorate (DGI, as per the Spanish acronym) has been experiencing deep structural and organizational changes, addressing and preventing to the best extent possible the challenges posed by an ever-evolving environment, with the purpose of guaranteeing greater efficacy and efficiency in fulfilling its mission as a Tax Administration, by a modernization process over several years.

Strategic Mission and Objectives

As an Executive Unit of the Ministry of Economy and Finance (MEF, as per the Spanish acronym), the DGI is the body in charge of collecting the revenue from the country's domestic taxes and the effective enforcement of the regulations providing for them.

In line with the strategic government guidelines and in the performance of its mission as a Tax Administration, the DGI follows strategic objectives aimed at:

* Pursuing two fundamental and supplementary courses of action: promoting taxpayers' voluntary compliance and detecting and punishing tax noncompliance;
* Rendering the public service by an effective, efficient, professional and integral behavior;
* Promoting tax awareness in society.

Such strategic objectives are gathered in the Strategic Management Plan 2005-2009 (PEG, as per the Spanish acronym), the Annual Operating Plans and the Management Commitments signed with the MEF.

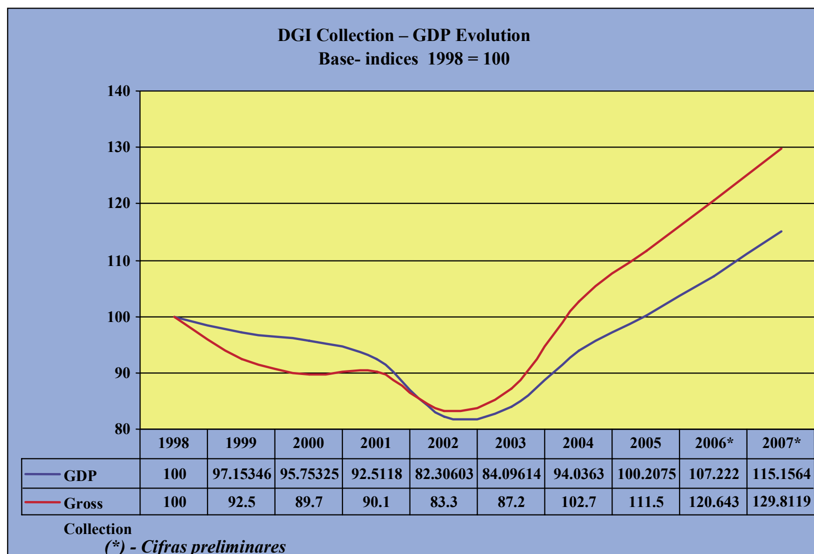
Products, users and processes

According to its mission, the end product of the DGI actions is represented in the volume of the collection obtained as a result of the application of the tax system administrated thereby. The figures representing the magnitude and evolution of this product are set forth in the following chart:

Figure Nº 1 – Collection

Collection			
In million pesos.			
YEAR	Gross Collection	GDP	In % of GDP
1995	17,538	122,521	14.31%
1996	24,172	163,546	14.78%
1997	31,893	204.926	15.56%
1998	37,702	234.267	16.09%
1999	36,826	237.143	15.53%
2000	37,403	243.027	15.39%
2001	39,221	247.211	15.87%
2002	41,214	260.967	15.79%
2003	51.726	315.681	16.39%
2004	66,385	379.353	17.50%
2005	75,435	406,706(*) (	18.55%
2006	86,806	464.802 (*)	18.68%
2007	100,717	541.868)*)	18.59%

(*) Preliminary figures according to the Central Bank of Uruguay



	1998	1999	2000	2001	2002	2003	2004	2005	2006*	2007*
GDP	100	97.15346	95.75325	92.5118	82.30603	84.09614	94.0363	100.2075	107.222	115.1564
Gross Collection	100	92.5	89.7	90.1	83.3	87.2	102.7	111.5	120.643	129.8119

We present the gross collection amounts in the first case, expressed in Million current Pesos for every year and the GDP in the 1995-2007 period. This last year gross collection amounted to 100,717,274 Billion current Pesos, equivalent to 4,293 billion Dollars[1]. Such figures account for 18.59% of GDP and 87% of the National Budget resources, required to finance public goods and services.

Secondly, such figure shows the collection evolution in constant values for the 1998-2007 period, which lets us observe its increase above the GDP growth as of 2002, taking as the basis the beginning of the period. The increase in gross collection in the 1998-2007 period amounts to 30% while in GDP grew by 15.2% in the same period. This accounts for a 15 percentage point gap between the growth in collection and production in ten years. Since there were no increases in tax rates, regardless of the economic evolution affecting collection, a large portion of this gap is explained by the improvement in the agency's management, obtained in the framework of its modernization and restructuring process.

From the users' standpoint, the DGI, in its capacity of Tax Administration provides a public service to society by supplying the resources enabling the State to meet its purposes, specifically, undertaking its social function. But the effective action of the DGI is undertaken on the universe of taxpayers, who thus become the direct users of the

[1] *Average annual Dollar rate 1 USD =$ 23.46*

products and services rendered thereby, by facilitating compliance with their obligations.

The tax scenario was modified as of July 1st of 2007 with Act Nº 18.083 of December 27th, 2006, which enforced the new tax system and determined the reduction from 28 to 13 taxes and incorporated the Individual Income Tax (IIT), which affected citizens in general. This strongly impacted planning, organization, systems and procedures in the DGI, for the nature of taxes under its administration as well as the increase in the number and type of taxpayers. In the past, the users of the DGI services were mostly businesses and tax advisors. The incorporation of the IIT introduced taxpayers levied for their own as well as third-party obligations, many of which until that time had never had a tax relation with the Tax Administration.

The following chart summarizes the make-up of the universe of taxpayers in the previous and subsequent scenarios to the enforcement of such law.

Figure Nº 2 – Taxpayers.

Taxpayers prior to Act 18.083

By type	Amount	%
Small businesses	36,268	16.86%
Medium-sized businesses (NON_CEDE)	168,230	75.04%
Large businesses (CEDE)	10,386	4.63%
Large taxpayers	234	0.10%
Total Taxpayers	**215,118**	**100.00%**

Taxpayers after Act N 18.083

By type	Amount	%
Small businesses	34,365	4.54%
Medium-sized businesses (NON_CEDE)	156,196	20.62%
Large businesses (CEDE)	10,064	1.33%
Large taxpayers	252	0.03%
Total Taxpayers	**200,877**	**26.51%**
- IIT Cat. I	52,008	6.86%
- IIT Cat. II	504,722	66.62%
Total IIT	**556,730**	**73.49%**
Total Taxpayers	**757,607**	**100.00%**

(*) Does not include Withholdings of Interest from Deposits and Other Financial Income, which are notreported since they are protected by Bank Secrecy and their status of Exemptions.

As it may be observed, prior to the Tax Reform, there were 215,118 taxpayers, while subsequently, we incorporated 556,730 IIT taxpayers, totaling 757,607 taxpayers under the authority of the Administration. The universe grew by 252%. This entailed an important effort to adapt to the new universe of taxpayers to assist and control.

3. POWERS, SOURCES AND INFORMATION SYSTEMS OF THE GENERAL REVENUE DIRECTORATE OF URUGUAY (DGI)

The DGI needs to rely on an integrated information system to appropriately develop its functions. The information system is based on the existence of the right of the Administration, stemming from a law, to gather tax-relevant taxpayers' information, in order to use it with the purpose of controlling the appropriate enforcement of taxes as well as the duty of third-parties to provide it.

The information thus obtained is an essential instrument in order to:

- Identify and register taxpayers who have met their obligation of registering in the taxpayer registry.
- Prepare and plan the work of the Administration unit that specifically performs compliance control, whether by extensive or intensive controls.
- Rely on comparative information in the self-assessment systems.
- Exchange information with other tax administrations, by virtue of the economic globalization context, in which the economic and financial obligations go beyond the borders of the countries and the existence of transnational corporations requires an appropriate cooperation in the IT sphere.

For the purpose of risk administration, all the information required shall be gathered to determine the possibilities of each alternative. The relevant information is captured and communicated in due time and manner to enable the Directorate to meet its responsibilities.
In such regard, we have detected certain risk areas. Consequently, by means of different resolutions, we determined information requests from taxpayers regarding tax-relevant transactions or large taxpayers. This information may be used to monitor their compliance, select taxpayers to be audited and in the auditing process thereof.

3.1. DGI Powers

The right of the DGI to obtain and use the tax-relevant information is not unlimited, but is contained by its own purposes. Obtaining the information pursues the basic end of enforcing the principle of tax and

tax payment equality according to the individual taxpaying capacity. Any use of the tax information other than the purposes for which it was filed would entail an essential disruption of citizens' trust in the DGI.

On such basis, the DGI is bound by information privacy and confidentiality, in the sense it shall be only employed for the effective enforcement of taxes and those to whom the information is disclosed, owing to their capacity, are bound by a strict obligation of secrecy and caution in its use. In case of breach of duty in this respect, they shall be admonished and upon serious violation, held criminally liable. Taxpayers are entitled to expect the tax-relevant information to remain under the strictest terms of confidentiality and any accidental disclosure shall immediately imply a liability for the responsible party.

Nevertheless, exceptions apply upon the DGI duty of privacy and confidentiality, in the cases of inquiries by the Judiciary, such as criminal cases, minors or customs affairs.

In spite of the confidential nature of the tax information gathered by the DGI, there are regulatory provisions that enable the exchange of certain data with other state agencies, among them, the National Customs Directorate, the Social Security Bank, and the State Insurance Bank.

Pursuant to Article 70 of the Uruguayan Tax Code, taxpayers and responsible parties are *mandated to contribute in the assessment, auditing and investigation efforts carried out by the Administration; and shall especially:*

A) *Carry the special books and records and document levied transactions in the form established by law, regulations or resolutions of collection entities.*

B) *Register in the applicable registries, in which they shall file the data required and duly communicate the amendments thereto.*

C) *Keep the books and other documents and records in good order during the term required by the levy, as defined in applicable legislation.*

D) *Facilitate inspections or examinations in any place, domicile, industrial or commercial facilities, offices, warehouses and transportation means for the authorized tax officials.*

E) *Present or file in the tax offices or with the authorized officials the statements, reports, bills of legitimate origin of goods and any other documentation tied to the tax obligations' generating events, and elaborate or clarify as requested.*

F) *Communicate any change in their situation that may originate a modification of their tax obligation.*

G) *Visit the tax offices as required.*

In turn, Article 68° of the Tax Code of Uruguay sets forth that Administration shall rely on the broadest powers of investigation and auditing and shall be especially entitled to:

A) *Demand from taxpayers and responsible parties the disclosure of the commercial books, documents and mail, of their own or of third-parties and require their appearance in the administrative authority to report information.*

B) Interdict the audited documents and take the security measures to protect them.

C) *Seize such books and documents when the severity of the case warrants it, for up to six business days. The measure shall be duly documented and only extended by the competent authorities, when deemed vital to safeguard the interests of the Administration.*

D) *Carry out inspections on personal or real estate property owned or in use, under any title, by taxpayers and responsible parties. Private domiciles shall be searched only after obtaining a search warrant.*

E) *Require third-party information, summoning them to appear before the administrative authority as required or when such information is not filed in due time and manner.*

F) *Request sufficient assurances with respect to the outstanding credits assessed.*

G) *Interdict or seize personal property when they lack the external control elements or stamps, seals or marks that determine the appropriate tax payment.*

When required for compliance of the foregoing proceedings, the Administration shall require a search warrant.

This article, together with the above, governs the relations between the Administration (the DGI) and the taxpayer (taxpayers and responsible parties).

As regards the request of third-party information, it is of great relevance as the control element in the performance of audits, since it enables to obtain information from a source external to the company.

Act Nº 17.930 of December 19th 2005 of the National Budget 2005-2009 (Art. 469) recently set forth that: "*all the state or non-state public bodies or agencies shall render, without any service in exchange, the data that are not protected by bank or statistical secrecy and required in writing by the General Revenue Directorate (DGI) to enforce taxes. The Judiciary and the Legislative branches are exempted from the obligation to render information, data or documents with regards to secret or confidential proceedings.*"

In any case, the idea is to preserve the essential values such as taxpayer equality before the tax and the contribution to government expenditure according to each taxpayer's taxpaying capacity. On occasions, the demand for information shall contradict other principles or values that equally deserve protection and pose limitations on the reporting requirements. As a counterpart to this disruption of "economic" secrecy we find the duty of confidentiality binding authorities and officials that know the information by virtue of their work and for the specific case of DGI officials, tax secrecy has been provided by law in the Tax Code.

3.2. Sources of information

Regular obligations and individualized requirements.

The reporting requirement is satisfied by information that is either filed or gathered. The information obtained by filing procedures is regular and automated, subject to legally pre-established contents and formats. Individual requirements, or information gathering, upon a request, shall detail the transactions, the taxpayers involved and the fiscal year. The individual requirement is used with the purpose of defining or comparing taxpayer's self-assessed information or to be used as an investigation instrument when the control mechanisms are insufficient.

In both cases, this DGI power shall be subject to the principle of legality, that is to say, a law of sufficient hierarchy shall exist to authorize its use by the DGI and, in turn, define the duty of taxpayers to provide the information required. From the foregoing statements we may observe that the Tax Administration enjoys the broadest powers to demand taxpayer's personal as well as third-party information. Systematically, and by means of voluntary compliance, taxpayers are required to file their tax statements in due time and manner and as required by the DGI, as well as keep their registry data updated. This is one of the main means by which the Administration gathers the data that shall be then turned into information.

Information filed.

The information filed by taxpayers as well as responsible parties is obtained from the taxpayers' statements. They may be classified as follows:

- Tax assessments (inherent information) and
- Informative (inherent and third-party information)

Likewise, on the tax assessments, there is a difference in the regularity determined basically by the taxpayer size and the tax applicable. Therefore, we may group them as follows:

1. For corporations:
- VAT Statements:

Six-monthly for small taxpayers.
Monthly for small and medium-sized taxpayers.
- Statements for specific taxes.

Monthly in all cases.
- Income Tax and Net Worth Tax Statements.

Annual in all cases.

2. For individuals:
- Income Tax and Net Worth Tax Statements.

Annual in all cases.

In the case of informative statements, the most important ones deemed highlighting are:

1. Taxpayers' and/or responsible parties' statements.
- IIT- responsible parties: withholdings, amount withheld and payment.

- IT for Non-residents- responsible parties: identifying the withholdings, the amount withheld and payment.
- Tax on the Transfer of Property-information on purchasers, sellers and real-estate property for sale, and other type of real-estate transfers.

2. Third-party information expressed in national currency:
- Credit card administrators- information by transaction of the selling company and the end consumer.
- Large taxpayers: details of purchases (levied and exempted from VAT) and monthly sales VAT identifying vendors and customers.
- Exporters requesting tax refunds identifying vendors and VAT purchase amounts.

3. Third-party information expressed in units of measure (kilos, liters) for certain economic activities deemed of tax risk.

Information gathered.

Likewise, the DGI gathers data that do not arise from tax statements. Such as:
- Information from vendors throughout the State.
- Information from the data identifying IIT taxpayers by responsible parties for employee information and liabilities.
- Information of the data identifying individuals by the National Civil Identification Directorate.
- Information on the actual real-estate property values by the National Cadastre Directorate.

Additionally, on-line access is available to the Data Base of the National Customs Directorate and the Social Security Bank.

3.3. Data and Information Systems

In the foregoing item, we made reference to information at all times, but we shall clearly differentiate information from simple data gathering. A datum is an attribute or feature that per se lacks sense, but if treated or processed appropriately may be used for decision-making processes. The datum per se does not constitute information, data processing is what provides the information.

Information is an organized set of processed data that constitute a message on a given situation or entity.

Information generation is aimed at:
- Increasing knowledge.
- Providing the decision-making party the raw materials to develop the solutions.
- Provide a series of assessment and decision rules for control purposes.

Lastly, an information system is nothing more and nothing less than an organized set of elements, to support the organization. Such elements are classified according to 4 types:
  - Individuals
  - Data
  - Activities or working techniques
  - Material resources in general

These sets of elements interact among themselves to process the data and the information and distribute it in the most appropriate form possible in the organization according to the objectives.

For risk management, all the information required to estimate the possibilities offered by each alternative shall be gathered. The relevant information is captured and communicated in due time and manner in order to enable management to meet its responsibilities.

For a long time, the Uruguayan DGI requested a lot of information from taxpayers without carrying out the appropriate and systematic process to rely on adequate information systems. Nevertheless, in the last few years this has been reversed, and different IT tools have been incorporated, which enable us to assert that we effectively rely on information systems.

The most relevant IT tools are:

The COGNOS Product Suite:

We adopted the Cogno product suite as a Business Intelligence (BI) tool. They meet the different requirements of the different types of DGI users. Such tools feature different functionalities such as security, metadata, information retrieval, and management of large data volumes efficiently.

The tool suite spans the following products:

- Decision Stream. It enables to retrieve, transform and enter data from different heterogeneous data sources, including Internet data or data acquired from third-parties to the Data Warehouse.
- Framework Manager. This tool enables to create the metadata common to the business (definition of the business rules), the packages (base structure to make up reports) and the cubes based on such metadata. It supports multiple data sources (different database administrators).
- Cognos Connection: a Portal enabling Web-based access to end users to the Business Intelligence information as well as the non-BI information.
- Query Studio: enables to perform Ad Hoc queries on the metadata (packages), creation of reports via simple procedures, it manages graphics, prompts, filters, calculation field and groups. The reports may be sorted on the Cognos Connection portal or exported to multiple formats.
- Report Studio: it is the tool employed in the creation of professional reports. Given its structure, it provides full coverage for any type of report, it enables to work with multiple data Queries, simplifying report lifecycle, enables the design of a different layout for each page and inclusion of large numbers of projects.
- Analysis Studio: it enables any person, beyond those who draft traditional reports and business analysts, to make their own multidimensional analyses and create OLAP reports (Online Analytical Processing), in Windows, Web or Excel environments.

Meycor COSO AG Software:

Meycor Coso enables to automate the implementation and assessment of the organizational internal control system. It includes the definition of roles with specific permits. It features an audits' module, to perform tests on the controls, which enables to assist in the auditing cycle (plan-execute-report-follow-up). It generates the risk maps by organizational areas and the general risk map.

Meycor Cobit AG Software:

Meycor COBIT AG enables to create and manage IT auditing software based on the Cobit auditing Guidelines. The product structure enables to define the COBIT objectives to be assessed for each project,

the sites to be audited, the procedures to be used and the auditors assigned to each objective.

ACL:

ACL is software for an in-depth analysis of the information in the current business and regulatory framework. It facilitates viewing the organization's information in a broader context, by enabling direct access and querying for all the transactions of any source and through any system. It saves time and reduces the need to request IT data.

With ACL organizations may achieve fast amortization, reduce risk, assure compliance with regulations, minimize losses and increase profitability.

ACL enables:

- The analysis of complete databases for complete certainty.
- The identification of trends, indicating exceptions with absolute accuracy and highlighting potential problem areas.
- The identification of errors and possible fraud.
- The identification of control issues and ensuring compliance with legislation and organizational rules.
- Calculating the date and analyzing financial transactions or transactions of any other nature affected by the lapse of time.
- Screening and standardizing data to guarantee consistency and accuracy in the results obtained.

4. RECENT RISK MANAGEMENT CASE

In the new scenario in which the DGI of Uruguay had to perform after the implementation of the new tax system, the creation of the Individual Income Tax is absolutely worth highlighting. As we have mentioned, it entailed a growth in the DGI taxpayers' universe in excess of 250%. In order to facilitate the administration of this new tax, a completely new taxpayers' registry was created, since the one employed by the DGI to that time had been designed to register corporations and the inclusion of individuals required the design of a new one.

The IIT enforcement system in the case of taxation of income from salaries and capital income is based on a source withholding system, to such an extent that in the case of an individual with a sole source of income, the withholding agent withholds the exact amount of the tax.

This means that the taxpayer is not required to file a statement, since the withholding is final. For those with more than one source of income, the withholdings do not necessarily assess the tax with accuracy, since they are applied individually on each source; therefore, the taxpayer, in principle, is mandated to file a tax statement. In addition to the fact that this is the first fiscal year in which the tax is levied and since it was enforced in the middle of the calendar year, we encountered cases in which the amounts withheld exceeded the applicable ones. Consequently, the next challenge posed by this new tax was to rely on timely and appropriate information, and for such purpose we needed to receive tax statements from taxpayers who were employed, and this required the appropriate assistance by the Administration. We exclude from this special assistance the self-employed taxpayers, chiefly professionals, who shall be assisted by the regular assistance procedure in place. We should bear in mind that this is a new tax affecting individuals who had never come into contact with the DGI, and lack a tax culture. Since this is the first fiscal year in which the tax is being levied, the Administration lacks a track record to assess the quality of the information available supplied by responsible parties.

In this regard, we worked according to the following stages:

4.1. Definition of the objective

The objective defined is to facilitate voluntary compliance of obligations for these new taxpayers, in order to rely on quality information to undertake a massive management of the most relevant taxpayers, effectively and within reasonable terms. As we mentioned before, the assistance for this new tax with a high quality level is part of the Administration's management commitment with the Ministry of Economy, since it is a significant aspect for citizens' acceptance of the new tax that their obligation with the Tax Administration does not occasion unnecessary time losses in conducting formalities.

The objective chiefly involves three areas in the Administration:

- The IT Division: bears the responsibility of making the assistance software operable in due time and manner, and the IT tools to facilitate the reception of tax statements on a decentralized basis.
- The Collection Division: provides personalized and telephone taxpayer assistance and their subsequent massive management.
- The Administration Division: facilitates the material and human resources required to undertake the procedures.

The objective may translated into the quantitative indicator defined as assisting 100% of the taxpayers requesting assistance, with a minimum 95% quality of service.

4.2. Objective-related processes and inherent risks

Processes may be broken down into:

- preparation
- campaign

Certain variables are analyzed for the preparation stage:

- Number of taxpayers that should potentially file statements, divided by type of income.
- Geographic distribution thereof.
- Mean time to prepare the tax statement with assistance by the Administration.

Firstly, we determined the mean time required to prepare the statement for a typical taxpayer.

Subsequently, we carried out an analysis to determine a potential taxpayer population required to file a statement. As mentioned, the parties required to file a statement would be the individuals with a sole source of income entitled to a tax refund and those with more than one source of income. In the first case, of a total 373,000 taxpayers with a sole source of income, we ran a simulation of their tax statements based on the available information from the responsible third-parties. According to this process, we succeeded in establishing the cases in which a tax refund applied for the excess tax withheld and automatically refunded such amount. A total 45,000 taxpayers were included in this assumption.

In the case of taxpayers featuring more than one source of income, we organized them by income amount, including a total 133,000 taxpayers. We considered a number with the likelihood of exceeding the assistance capacity, and consequently, determined that taxpayers with income under a certain amount would be exempted from the obligation of filing a tax statement, using the withholding amounts as the final tax, when applicable. After this screening process, 57,000 taxpayers are required to file tax statements and deemed potential users of the assistance to be implemented.

Thus, we reached a number of taxpayers that the Administration would serve effectively according to the cost-benefit ratio.

In turn, we analyzed their geographic distribution to decide the location of taxpayer assistance offices and the human and material resources required.

4.3. Risk Management Actions

After defining these parameters, we undertook the following actions:

- Promotion of appropriate norms to attain our objectives. We issued the decree establishing the tax statement exemption for those who earn income under a given amount, and the resolution that determines the deadlines' calendar for the purpose of organizing and rationalizing the visit of taxpayers to the service offices especially created for the purpose of this effort.
- A credit refund system was put in place for credits assessed automatically through their employers or social security withholding agents, informing taxpayers on the amount and date on which the money shall be credited.
- Temporary employment of over two-hundred university students to provide assistance, who are trained to appropriately assist taxpayers visiting our offices for assistance.
- Special training of officials from the management and auditing areas to perform supervision functions in the service offices.
- Call center improvement, to provide telephone assistance to taxpayers.
- Monitoring tax statements filed on a daily basis in order to manage communication with taxpayers via different communication means, encouraging their visit or not, and summoning them to our offices.

4.4. Management Outcomes

The effort was carried out between May 28th and September 5th of 2007. The number of taxpayers required to file statements was reduced, prior to the analysis and execution of the actions, from a total 178,000, which included taxpayers with a sole source of income entitled to a refund and those with more than one source of income, to 57,000 deemed manageable in the first fiscal year by the Directorate.

During such period, over 54,000 statements from the expected 57,000 were received, which renders less than 5% noncompliance and a quality of service level in excess of 98%, above the amount deemed acceptable. From the total statements received, 70%, almost 38, 000 were completed via the assistance system specially implemented by the DGI. The remaining 30% were completed and filed electronically directly by the taxpayer.

The information received featured a high level of quality, which shall facilitate the subsequent tax management. This achievement was possible owing to the appropriate assistance for taxpayers requesting it in the preparation of their statements as well as in providing the information necessary to complete them. Reception of the statements completed in all cases with the available assistance software enabled to validate the data entered, ensuring their consistency.

5. CONCLUSIONS

This document intends only to provide a simple presentation of the recent experience of the Uruguayan DGI in facing a new scenario, for which it relied on international background, but which constituted a very risky situation. Waiting for events to occur and reacting in consequence would have entailed a very high cost for the Uruguayan Tax Administration. In conclusion, risk management efforts in this stage succeeded in the objective, enabling the Administration to successfully carry out the first Individual Income Tax assistance campaign.

In general terms we may conclude that the main benefits of the risk management effort are:

- More effective strategic planning.
- Better outcomes vis-à-vis efficiency and effectiveness of specific programs.
- Greater transparency in decision-making and processes underway with regards to management.
- Surprises without greater costs.

Case study

Topic 3.2

THE USE OF TECHNOLOGY: INFORMATION SYSTEMS AND DATABASES

Oscar Franco
General Director
Directorate of Taxes and National Customs
(Colombia)

CONTENTS: Introduction.- I. Scope of DIAN.- II. Fiscal risk management at DIAN.- III. Proper technology supports risk management strategies.- IV. Risk management strategy consistency.- V. Conclusion

INTRODUCTION

Tax Administrations face changing and sometimes unforeseeable environments, where trade liberalization and capital movements, increasingly virtual and electronic trade practices, open and technical contraband, money laundering and fictitious transactions pose a constant challenge to Tax Administrations in the pursuit of their mission: collecting taxes, controlling compliance with tax obligations, verifying regulatory compliance of foreign trade transactions, controlling borders and intellectual property.

Taxpayers perceive tax evasion is likely to be detected when they perceive the Tax Administration is efficient. By the same token, the actual risk is consistent with the administration´s capability of carrying out large-scale and thorough examinations. For this reason, risk management becomes an essential tool to timely respond to changes in the environment as well as to gear management strategies towards

higher priority areas, together with the optimum use of tax administration resources.

In this sense, the National Tax and Customs Administration of Colombia has based its risk management organizational strategy on integrating its work with the automated Single Model for Revenues, Service and Control (MUISCA), whose implementation has strengthened its

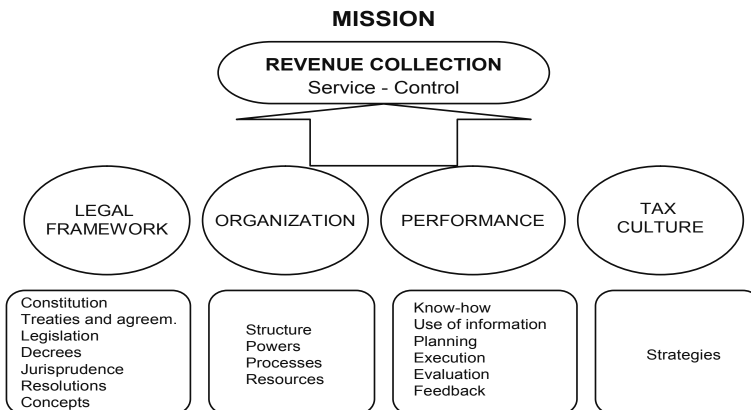
organization and mission-based collection and control actions. This has led to better service and early communication with tax payers and different intermediaries, and has enhanced tax administration responsiveness and transparency, through the leverage of information technology, with its best theoretical and commercial practices.

Since MUISCA is a comprehensive management model which guides organization, personnel, technology and processes, the following presentation illustrates the use of information technology in the design, construction and implementation of risk management efforts within DIAN.

I. SCOPE OF DIAN

DIAN is an agency of the Colombian State whose purpose is "aiding in ensuring tax security to the Colombian State and protection of the national, public and economic order, through the administration and control of compliance with tax, Customs and exchange obligations, and through the facilitation of foreign trade transactions in conditions of equality, transparency and legitimacy". Therefore, it is imperative to consistently link the agency´s mission and management of processes, people and resources with the risk management strategy in terms of efficiency and efficacy, factors which become truly relevant in the light of state viability itself.

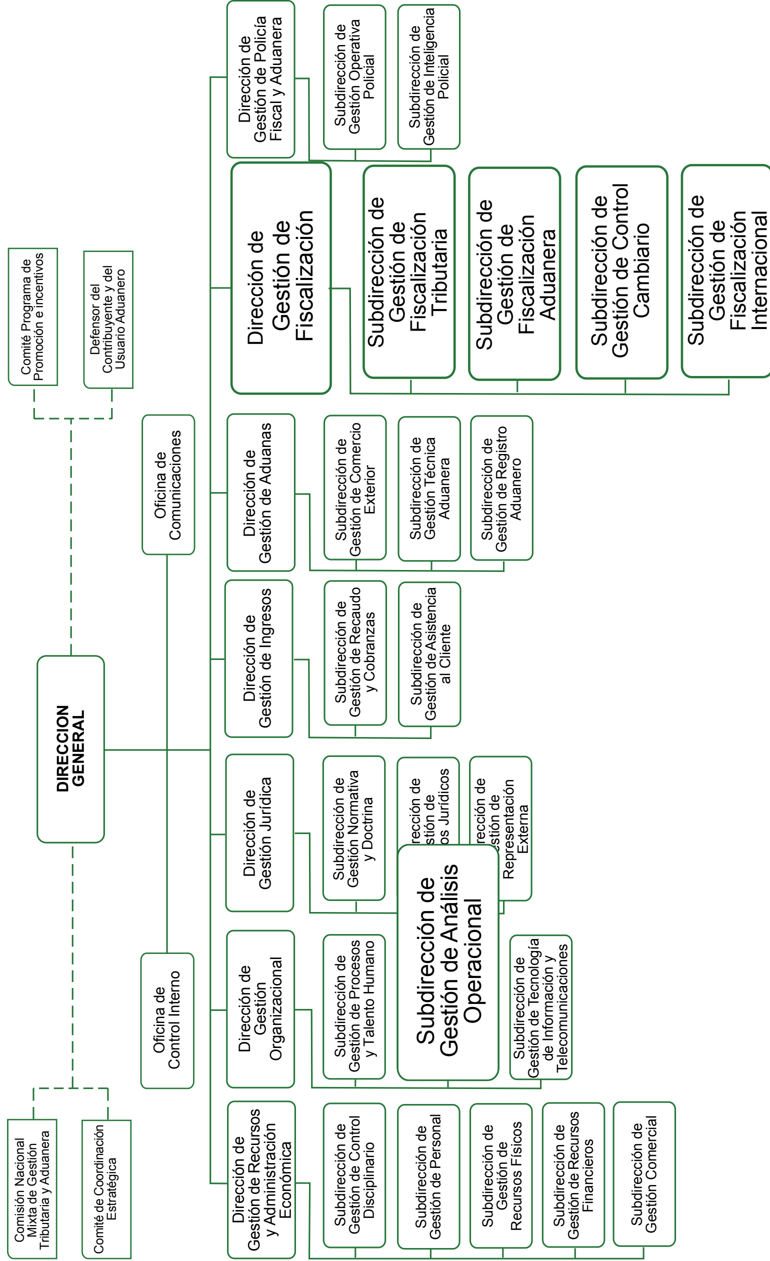
Strategically, DIAN is the agency responsible for facilitating and controlling economic agents towards compliance with the tax, Customs and exchange regulations, following the constitutional principles of the administrative role: collecting the right number of taxes, facilitating foreign trade transactions, fostering fair trade conditions, providing reliable and timely information and contributing to the social and economic welfare of Colombians.



To ensure fulfillment of its mission, DIAN follows the regulatory framework set forth by the Political Constitution, treaties and agreements, domestic legislation, decrees, jurisprudence, resolutions and concepts. It manages an organization whose structure, powers, processes and resources are based on the new management model.

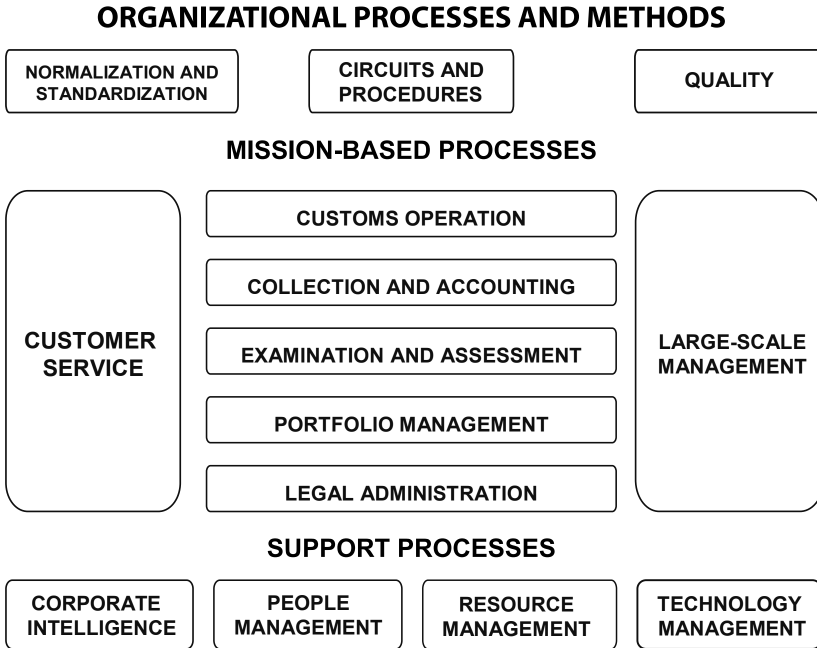
Some significant aspects of performance are: know-how, use of information, planning, execution, evaluation and feedback, strengthened by the framework of a tax culture based on strategies geared at transparency.

Now, DIAN´s risk management strategy is enhanced through an organic structure for process, quality and control management and human talent management based on competencies, which in conjunction, allow for curbing inherent risks. Thus, without losing sight of the mission of collecting and of the service-based approach, we strengthen both inspection efforts and actions management, where analysis of transactions and risk profiling play a relevant role in terms of effective control.



Estructura Orgánica Propuesta- Nivel Central
DIRECCION GENERAL
Comisión Nacional Mixta de Gestión Tributaria y Aduanera
Comité de Coordinación Estratégica
Comité Programa de Promoción e incentivos
Defensor del Contribuyente y del Usuario Aduanero
Oficina de Control Interno
Oficina de Comunicaciones
Dirección de Gestión de Recursos y Administración Económica
Subdirección de Gestión de Control Disciplinario
Subdirección de Gestión de Personal
Subdirección de Gestión de Recursos Físicos
Subdirección de Gestión de Recursos Financieros
Subdirección de Gestión Comercial
Dirección de Gestión Organizacional
Subdirección de Gestión de Procesos y Talento Humano
Subdirección de Gestión de Análisis Operacional
Subdirección de Gestión de Tecnología de Información y Telecomunicaciones
Dirección de Gestión Jurídica
Subdirección de Gestión Normativa y Doctrina
Representación Externa
Dirección de Gestión de Ingresos
Subdirección de Gestión de Recaudo y Cobranzas
Subdirección de Gestión de Asistencia al Cliente
Dirección de Gestión de Aduanas
Subdirección de Gestión de Comercio Exterior
Subdirección de Gestión Técnica Aduanera
Subdirección de Gestión de Registro Aduanero
Dirección de Gestión de Fiscalización
Subdirección de Gestión de Fiscalización Tributaria
Subdirección de Gestión de Fiscalización Aduanera
Subdirección de Gestión de Control Cambiario
Subdirección de Gestión de Fiscalización Internacional
Dirección de Gestión de Policía Fiscal y Aduanera
Subdirección de Gestión Operativa Policial
Subdirección de Gestión de Inteligencia Policial

Process-based management at the Tax Administration facilitates process control, the incorporation of quality systems and, in brief, leads to organizational efficacy.



II. FISCAL RISK MANAGEMENT AT DIAN

Compliance with fiscal regulations is largely determined by the pressure that the tax administration may exert toward compliance with tax obligations. The probability of detecting tax evasion, as perceived by the taxpayer, is directly linked to the Tax Administration efficacy in all spheres of action: collection, examination and inspection, control, collection of dues, service and interaction with taxpayers, internal organization and interaction with other State agencies.

Below, we indicate some actions which have made up the strategy on which the comprehensive risk management model of DIAN has been based in the past five years, for generation and risk analysis, as part of the effort to reduce evasion and contraband.

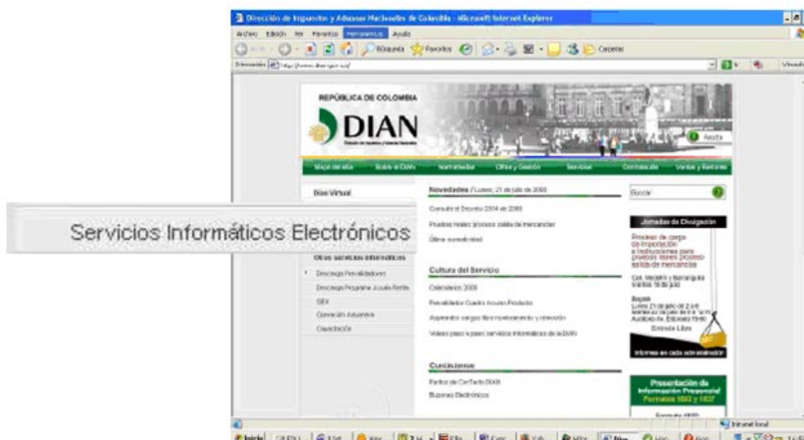
1. Interaction with taxpayers

Interaction with citizens, as part of the risk strategy, allows DIAN to be widely present through numerous channels in many sectors which would not be reached in absence of the adequate technology. Besides providing citizens with security and advice so that they can better comply with their tax obligations, this interaction shows the Tax Administration knows its taxpayers, which combats informality and discourages evasive behavior. Within the context of MUISCA Model, virtual, telephone and face-to-face communication with the citizens is strengthened, since users and taxpayers are offered different alternatives through different media. These services include information which is conveyed, communicated and published, as well as Transactional Electronic Information Systems provided freely and equally to all users, through:

- Virtual interaction

Through DIAN´s portal, www.dian.gov.co, which is a channel of virtual communication and interaction with taxpayers, tax filers, the academia, the research community and citizens in general, the agency offers the following web-based services: information, education and assistance. It also facilitates compliance with obligations and procedures through electronic information systems, for general public, in a secure, free and modern environment.

All virtual interaction systems are offered online at DIAN´s virtual page, which includes the necessary material such as brochures, videos, tutorials and instructions for virtual training.

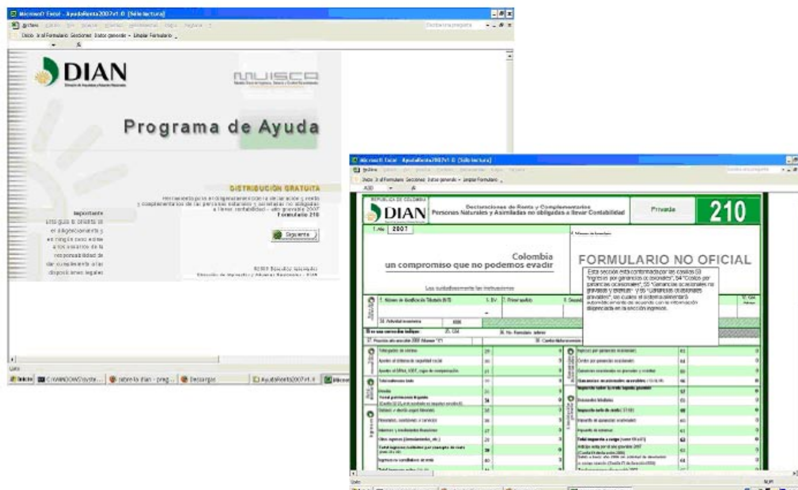


- **Telephone interaction**

Through a single, two-tiered Call Center, DIAN provides service and guidance to users individually and solves doubts and difficulties around compliance with obligations towards the agency. Through the site, the Tax Administration also summons taxpayers, individuals who have filed for tax registration, withholding agents and assessors, to provide assistance in different processes.

- **Face-to-face interaction**

Through Points of Contact, DIAN expands the scope of its coverage, to provide comprehensive face-to-face service to citizens and help in total or partial self-assessment to taxpayers, in facilities with proper physical, logistical and IT equipment. These activities are supported by personnel specifically trained in face-to-face service, who help taxpayers with their paperwork and lodgings. These facilities also offer services requiring the use of computers, telephones, points of payment, photocopies, etc., that is, all the relevant services and tools for single-point management. At present, DIAN has 57 Points of Contact, to provide service to customers with extended opening hours, ensuring wider coverage and consistency of information and criteria.



2. Information gathering

Information gathering, as component of the risk strategy within the framework of MUISCA model, ensures taxpayers compliance with tax obligations through modern, free and secure Electronic Information

Systems. This significantly improves the information gathering procedure, as well as its quality, timeliness, coverage and security, through the use of open technology which strictly complies with the standards widely used in the IT industry.

The availability of physical and electronic documents, standardized and normalized, such as tax return forms, official payment receipts, and, in general, tax, Customs and exchange information, required in line with DIAN´s powers, conveys clear risk perception in so far as it is possible not only to gather a larger amount of information, but also because it is possible to better treat and leverage said data, which leads to higher compliance levels. Both the timeliness and the quality of information allow for the possibility of imposing sanctions on the grounds of formal aspects and of implementing the essential actions that the tax administration may undertake effectively on basis of said information.

Furthermore, the extensive information gathered by DIAN enhances the capacity of analytical processes, since the link of individuals and transactions leads to the identification of risk behavior and profiles. Part of the information DIAN obtains from external agents is provided by:

Financial entities
Chambers of Commerce
Stock Exchanges and Brokers
National Civil Registry
Notary Public Offices
Typographers and lithographers
Individuals and legal entities
Non taxpayers
Economic and/or business groups
Currency exchange bureaus and money carriers
Entities which have signed cooperation agreements
- Voters registry
- Risk assessment offices
- Geographical Institute
- Security Department
- Embassies
- Andean Community
- Government Ministries
- National Bank
- Municipal treasuries

- **Virtual processing and filing of documents**

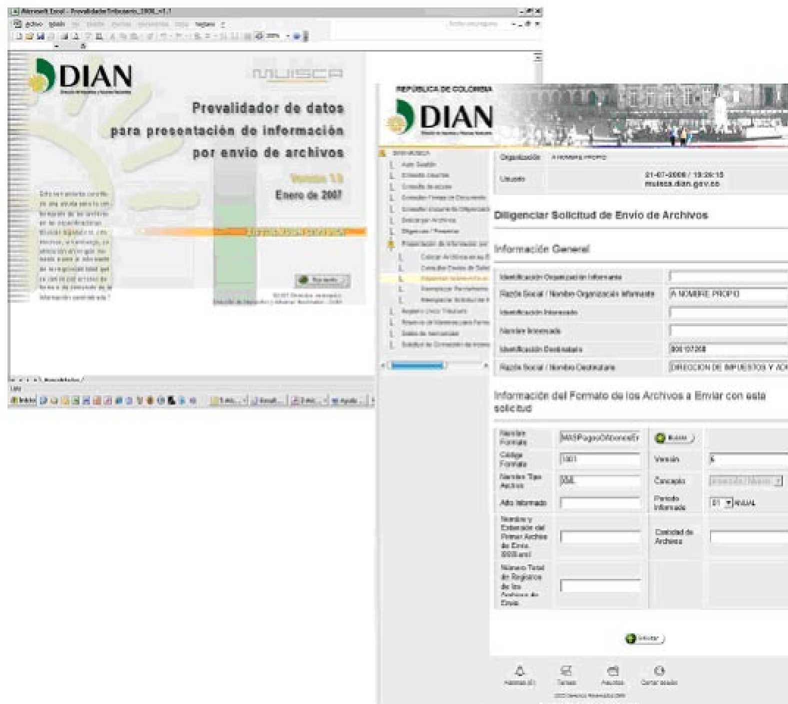
DIAN customers have free and virtual access to forms, and through web-based service, it is possible to obtain virtual, secure, technical and legal assistance for taxpayers, over tax returns, Customs and exchange bills and official payment receipts, using a digital signature mechanism supported by a digital certificate issued by DIAN.

- **Reporting general information**

By offering electronic means and channels for virtual delivery of information, DIAN facilitates the presentation of economic, transactional, financial and general information, which allows the agency to engage in actions aimed at promoting and examining full compliance with tax, Customs and exchange obligations.

- **Document processing**

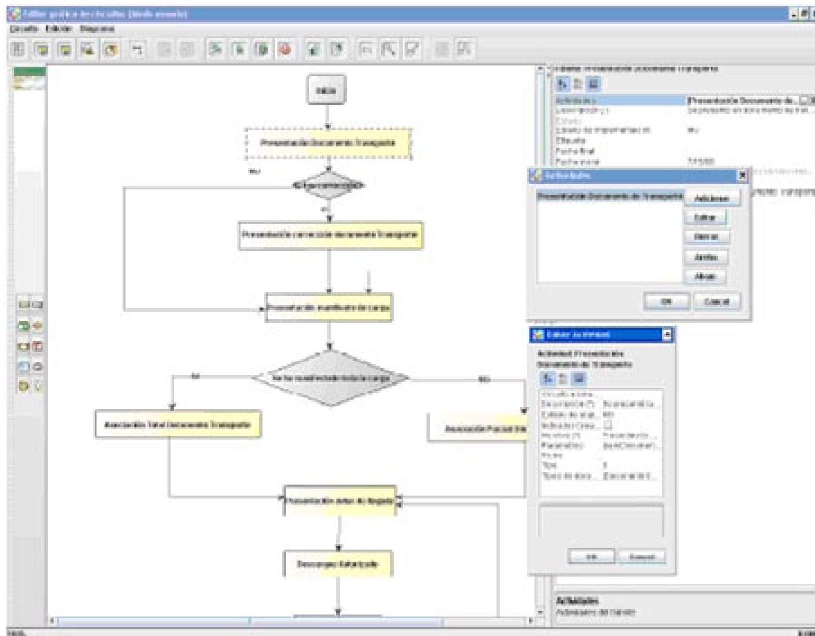
The regulatory, logistical and technological streamlining of the processing of physical documents submitted or generated at the Agency, includes procedures for communication, notification and filing management for all documents, from their reception, registration, digitization and packing, to their physical and electronic storage. This helps DIAN comply with quality and security standards required by modern administration.



3. Management transparency

DIAN´s visibility and capability of examining all actions and information discourages citizens and officials from engaging in manipulative practices. This reduces fraud and corruption risks and fosters full compliance with the obligations, and prevents undesired actions in favor of transparency.

Since mission-related processes (collection of taxes and dues, inspections, rebates, imports, etc) and administrative processes managed by the administration are defined, standardized and systematically and automatically controlled through MUISCA, it is possible for the Administration and the citizens to follow up on procedures, their duration, the intervening individuals and the adequate flow of actions from beginning to end, warranting they are clearly defined and controlled, not only by the administration but also by the citizens, thus ensuring traceability and generating confidence and transparency, both internally and externally.



The following processes and services are a clear example of transparency and traceability:

- **Accounting of revenues**

As part of the risk management strategy, DIAN does the accounting of collected revenues in a comprehensive and auditable manner, and with the support of documents such as tax returns, official payment receipts and administrative acts, to the point of disclosing in specially created accounts possible distortions derived of information inconsistencies. This leads to fast accounting correction and to reliable information, which is in turn input for mission-related processes.

- **Statements of account of tax obligations**

The generation of movements, balances and statements of account of tax obligations (tax, Customs and exchange) resulting from the application of rules and procedures pursuant to the legislation and the information included in private assessments, final administrative acts and payments and the availability of said information on documents which the taxpayers may consult with and where it is possible to know and understand the cause of the balance without any intervention of

a DIAN official, is a powerful tool supporting the Tax Administration management and is an excellent information mechanism for the customers who exercise their rights.

- Timely correction of inconsistencies

Timely detection and correction of inconsistencies in tax returns and payment receipts improve timing and minimize later cost assessments and discussions about obligations in favor of the Tax Administration and of the tax payers and filers.

The procedure itself is guarantee of transparency and control, since this process, from the moment an inconsistency is detected until its correction, which includes different procedures, is fully reflected in visible format at all times to the taxpayer and access is regulated on the basis of whether it falls on the latter or an official to carry out some action.

Detalle asunto

N° Asunto:	200801850100000200		
Nombre Asunto:	Proceso de Exportación: Solicitud de Embarque No. 602700016124 Presentada. Solicita Embarque		
Año apertura:	2008	Estado:	Abierto
Monto:	0	Tipo asunto:	Caso

Ver Imagen

Procedimientos | Personas | Documentos | Jerarquía

	Descripción	Fecha inicial	Fecha Final	Cantidad de documentos	Cantidad de Personas	Duración (hh:mm:ss)	Estado	N° tareas pendientes
	Solicita Embarque	27-03-2008 / 09:30 AM	27-03-2008 / 09:30 AM	1	1	00:00:00	Abierto	1

Actividades para clientes

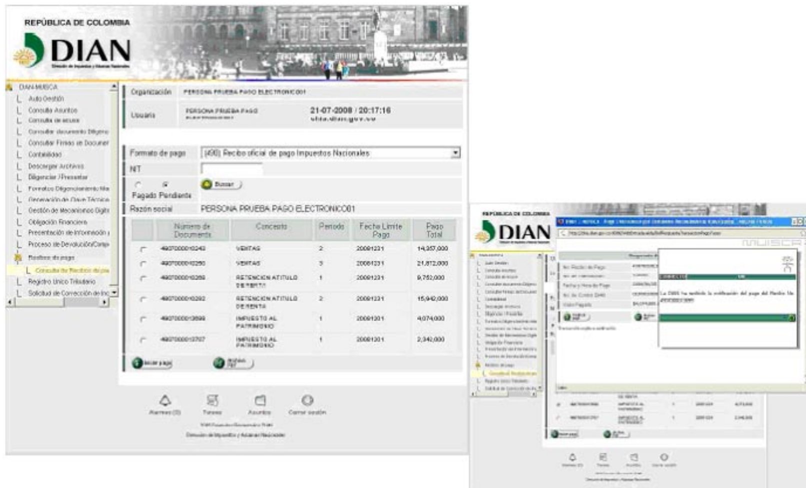
Num. Identificación	Nombre	Responsable	Tarea	Estado tarea	
777777772	PRUEBA 2 EXPORTACIONES	Tercero	Tiene pendiente realizar el traslado de la mercancía registrada en la SAE 602700016124 a zona primaria	Activa	

Regresar

4. Exchange of information

Fragmented, diverse and scattered information at different state agencies weakens the inspecting functions of the Tax Administration,

to the detriment of full compliance with tax obligations. We mitigate this risk within the scope of MUISCA through the exchange of information supported by the standardization of concepts and data, the definition of standardized representation languages and by the implementation of technology which allows for the interoperability of different IT systems, since it is open and non intrusive.



5. Knowledge creation

Creating knowledge is a complex process requiring effective interaction with the taxpayers, information gathering, transparency and traceability of actions as well as further interaction with other State agencies. Clear information submitted by taxpayers and by third parties about them, in addition to the development and application of scientific, mathematical, probabilistic and classificatory concepts, together with information processing and analysis tools, allow for the identification of individual behaviors, profiles, transactions and collective information, on the basis of which we apply specific actions leading to regulatory compliance, as well as to detection and prevention of malfeasance, evasion and avoidance.

Since information is the main deliverable and input in knowledge creation, its use increases in terms of volume and quality within MUISCA, so that it is possible to perceive risks related to taxpayers, while adequately leveraging and treating said information, as indicated above, so that risk is identified and the tax administration is increasingly capable of intervention.

In fact, the intelligent, efficient and efficacious use of 100% of the data received by DIAN, together with the use of statistical sampling models, neural networks, logical models and indicators, has allowed the agency to establish behavior profiles, select cases and create knowledge, so as to match information, carry out inspections and controls and identify and select with greater certainty the possible cases of omission or errors in complying with tax, Customs and exchange obligations.

This also leads to stronger inspection processes, which among other institutional goals, include collecting tax dues, protecting information and identifying risks through the effective assurance of compliance with obligations, based on broad powers which include:

Verifying tax returns
Summoning taxpayers or third parties
Carrying out tax inspections
Inspecting accounting books
Drawing records
Implementing necessary procedures for tax assessment.
Deploying technical control systems
Imposing sanctions

The Tax Administration carries out the necessary administrative procedures, such as:

Opening order
Ordinary requirements
Subpoenas
Inspection order
List of charges
Special requirements
Extension of special requirement
Official assessment
Punitive order
Order admitting or rejecting recourse
Ruling which settles recourse

All the above is enhanced by the possibility of applying sanctions related to the following facts:

Failing to report information
Failing to lodge returns
Lodging delinquent returns

Correcting tax returns
Reporting inaccurate information
Failing to issue invoices or doing so without meeting requirements
Bookkeeping irregularities
Omitting assets or including nonexistent liabilities
Rejecting or reducing losses
Failing to comply with RUT (Single Tax Registry) related obligations

In view of this, the fight against non compliance includes intelligence work to make strong inspection efforts, so that the identified risk is tackled with actions and perceived detection capability becomes the factor which determines effectiveness.

III. PROPER TECHNOLOGY SUPPORTS RISK MANAGEMENT STRATEGIES

Since risk management strategies are broad, complex and cover all aspects of DIAN, it is necessary for information systems to include the needs of all the areas and processes, so that the acquired and/or developed technology meets the necessary conditions to support the strategies. It is also necessary to include the disciplines on which knowledge generation is based, statistics and mathematics, among others, as well as the application of state-of-the-art concepts supplied by the best practices in software engineering and to implement the technical architectures of reference to model, manage and control data, processes and resources, as supplied by the IT and telecommunications industry.

DIAN´s information system and data base are based on criteria which facilitate their operation and enhance the Administration´s processes:

Unity: this criterion of the information systems refers to a single definition of each concept at DIAN. Each concept (taxpayer, tax, form, resource, site, process, etc) should also identify the relations it has with the other concepts and include their management through clearly defined automated or non automated procedures.

Flexibility: The information system on which the risk strategy is based applies comprehensive and general concepts of patterns of information, hardware, software and communications, which allows for adjustment to all mission-related or support processes at DIAN.

Sustainability: mitigating the risk of captive single agents in the IT industry, is one of the pillars of technology leverage. In fact, using open designs and standards allows for control of the impact associated to single providers and technological obsolescence, while it gives way to competitive bidding processes of acquisition which favors DIAN´s cost structure.

Connectivity: the use of open and widely shared standards for information exchange and services, allows DIAN to establish internal and external links in a controlled and standardized manner.

Security: the continuity of DIAN´s services is safeguarded through a single security model, based on the most stringent tools and standards

in IT security. This model includes procedural, logical and technological support for access, custody and service recovery.

Capacity: Assuring the use of information in all transactional and intelligent processes and in knowledge generation demands the availability of resources which allow for full use of all processes. Adequate computing, processing, storage, concurrence and transmission capacity is key to DIAN´s information system.

Traceability: the possibility to easily examine, verify and show the implementation of actions and transactions in compliance with administrative and technical procedures warrants transparency and responsiveness, as well as prevention of non desired actions, in the search for transparency.

Adjustability: this criterion allows DIAN to adjust to specialized IT tools which enable the generation of knowledge, contributing to the efficacy of the Tax Administration.

Now, since the goal of this presentation is not advising readers about a certain architecture and/or IT product, but rather, to illustrate with practical cases the use of technology and data bases, the following examples show the type of technology used by DIAN in its risk management strategy.

Technology used

1. Interaction with citizens:

We use technologies allowing for more dynamic interactions and for management of complex data structures for visual procedures, such as definition of formats: Java EE, XML, Applets.

XML supports information storage of the visual structure of a certain format. Java EE is the platform on which all services are built.

This allows the application to run on any computer with Internet connection.

2. Information gathering:

We use technologies for the implementation of web interfaces which manage the input of information and its validation. All the technologies combine to provide the customers with user-friendly experiences when lodging their returns.

JSP (Java Server Pages), JSF (Java Server Faces), JavaScript, Servlets, Java EE, Digital Certificates. Digital Certificates are used to authenticate the person filing in the information and thus avoid rejection.

XML technology is used for standardizing the way we send information. This is achieved through files based on a structure defined by a standard known as "Esquemas".

XML, JSF (Java Server Faces) and VBA for applications in the assistants for the processing and generation of files offline, complying with the XML standards required by the Tax Administration.

Java Server Faces is used in the implementation of user interfaces, which allows taxpayers to visually deliver to DIAN the required information.

3. Transparency of work:

Technologies for the implementation of process flows defined through the design of circuits which are so user-friendly as to allow for visual definition of such.

XML is the chosen means for storing circuit visual structures. Java EE is implicit, since the process may be run from any computer with Internet connection. All the system is built on a service business platform: Java EE, XML, Applets.

Traceability of cases: Cases and files.

Technologies used for consulting and visualizing images of processes run under a certain subject, case or file.

Java Server Faces is used to create the interface which allows for checking on cases and their status (open, closed). Besides, it allows

for surfing the cases and obtaining information on the procedures run (and their timing), the individuals and the documents involved.

Viewer is the tool for graphic visualization of the path followed by a case in particular at a certain point in time.

4. Exchange of information

Web Services is a technology designed to create distributed Service Oriented Systems (SOA), for the interaction of systems created on different platforms, but which stick to certain information exchange methods, following the standard set by XML schemes.

We used Java Server Faces since some of these procedures require doing a set of operations before the actual exchange of information.

In case of RUT (Single Tax Registry), information is exchanged between the Single Tax Registry and the Chambers of Commerce.

As regards Electronic Payment, online exchange of information and transactions are carried out between DIAN systems and those of different agencies cleared for collecting taxes, as well as those agencies authorized by the National Tax and Customs Administration to offer electronic payment for the different obligations managed by the Tax Administration.

Likewise, different control agencies and DIAN exchange information and process approvals online to authorize imports and exports of goods into and out of the country, by means of Single Point Interconnectivity with the Ministry of Foreign Trade.

5. Knowledge creation

Statistical tools for building import risk models.

To identify contraband in Colombia, we use three (3) statistical tools, namely: neural networks, construction of an index and a logistical model. In the first case, the purpose is implanting a neural network for the detection of contraband in Colombia, with the minimum margin of error possible, using data bases of imports and inspections carried out by DIAN.

- **Neural networks:**

The strategy consists of testing the different network configurations until we find the most adequate one. When new data which are not part of the previously defined set enter the network, the neural network is capable of detecting if there is contraband or not within a certain margin of error. The first trials made by the National University show that it is possible to build a network which can detect contraband with a 6.7% margin of error.

We use neural networks to follow up on importers for a certain period of time, and test the network with retrospective studies, using data bases from previous years and then validating those trials.

Variables used
Entry (19)
Type of return
Warehousing
Activity
Exporting country
Source country
Flagship country
Point of entry
Method
Consignment
Consignment volume
Country of origin
Purchasing country
Packaging
Administration
Unloading
Means of transportation
FOB value
Exit (1)
Customs release

- **Contraband index**

We have designed an index to detect contraband goods, using variables derived from inspection procedures and observing behaviors during seizure of goods. This index is built on the basis of information obtained from import documents. We assign numerical scores to the different variable categories, and the result defines a reference value, based on which the case may be presumed as contraband.

When we inspect or examine certain selected import documents once the goods have been released from Customs, we estimate a previously defined index quantitatively over a number of entry variables.

Said calculation results in a value which is verified against a threshold value, also precalculated on the basis of previous cases of seizure or non seizure of goods.

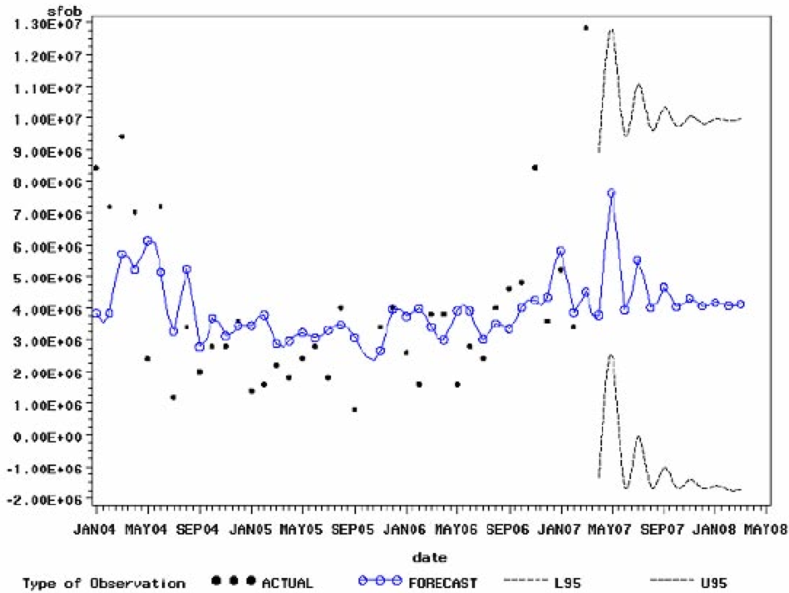
- Logical model with two controls per seizure

The Logical Model is the third statistical tool used to determine irregularities in the import of goods. In general terms, we try to define the influence of different factors (packaging, weight of goods, country of origin, etc) and the value or level of said goods in terms of how likely it is to come across import irregularities.

Use of time series:

The analysis of time series is based on data mining concepts for time series and helps in formulating statistical techniques which allow for designing models and proving hypotheses. Besides, it allows us to know the profile of the object under analysis, such as importers, brokers or any of DIAN´s clients.

The methodology is based on the use of time boxes to make requirements about time series. Thus, time boxes are rectangular regions which are selected and directly manipulated in a fraction of the time series. The threshold values specify the relevant parameters of the requirement. A pattern is specified for a particular time window and then these patterns are searched for in this series and in other series, identifying when and where similar behavior has occurred. Additionally, the series may be filtered, staking out a rectangle for a defined period, to reduce the search window.



(PRESENT VALUES, FORECASTS, CONFIDENCE INTERVALS
Imports per importer)

- Time series with neural networks.

The goal is observing the behavior of importers in relation to the seizure or non seizure of goods over time and thus be able to predict the behavior in a case of seizure. We also try to draw comparisons with “clean” importers, that is, those who during that period have had no goods seized.

Relational data bases, flat files and statistical packages are the technologies chosen for the implementation of statistical and probabilistic analysis.

Design of rules for the cases of underdeclaration of income based on:

- Consolidation of all the information in variables
- Formulation of bookkeeping and financial rules for third party information.
- Generation of taxpayer profiles.

Tools for consolidation and formulation of rules, XML, Rules Engines, Data cubes.

XML and Rules Manager are used to obtain and validate information so that it is correct and totally usable.

Data cubes allow for optimal leveraging of information according to different needs. Data cubes and the rules engine allow for general processing of information in the best way possible pursuant with the defined requirements.

Flex is a technology for creating RIA Applications (Rich Internet Applications), which are in turn web applications delivering operational experience as user-friendly as desktop applications.

IV. RISK MANAGEMENT STRATEGY CONSISTENCY

Attributing risk management strategy effectiveness only to organizational aspects does not apply to DIAN, where both actual risk perception and generation on the part of the taxpayer are reflected in actions measured and shown through indicators, which are mutually consistent, of the processes, reflecting the model consistency, that is, the correspondence between plans and results, as shown below:

Indicator	2002	2006	2007
Tax returns filed for excise duties	4.612.047	5.738.299	6.902.298
Virtually lodged tax returns	90.000	260.161	1.070.298
Import declarations	850.984	1.895.288	2.147.809
Export declarations	257.413	401.498	422.240
Taxpayers compelled to report information	27.546	144.656	157.506
Virtually submitted records (million)	27	92	111

Indicator	2002	2006	2007	2008
Gross collection (trillion $)	27.5	52.7	60.1	67.8
Collection growth rate	10.7%	20.9%	13.9%	12.7%
GDP growth rate	7.9%	12.9%	9.2%	8.1%
Collection as GDP percentage	13.4	16.6	17.1	17.9
Collection by officials (billion)	3.4	6.5	7.4	8.2
Income evasion rate	36%	31%	30%	28%
VAT evasion rate	24%	22%	21%	20%

Indicator	2002	2006	2007	2008
Number of control actions	65.486	209.651	235.709	240.000
Institutional presence in Municipalities	120	492	527	550
Portfolio as revenue percentage	19%	12%	10%	8.5%

Indicator	2002	2006	2007	2008
Registered in RUT	750.000	3.348.826	4.447.063	4.821.009
Registered in RUT, in Income Tax	395.000	1.408.809	1.556.730	1.590.394
Registered in RUT, in Regular VAT Regime	221.000	466.099	513.400	529.423
Registered in RUT, in Simplified VAT Regime	611.000	1.840.170	2.666.801	2.956.914

FIRST OR SINGLE INSTANCE				
	TAX	CUSTOMS	EXCHANGE	TOTAL
CANCELLATION AND REINSTATEMENT	2256	3753	131	6140

SECOND INSTANCE	
	TOTAL
CANCELLATION AND REINSTATEMENT	1112

V. CONCLUSION

Risk management success at Tax and Customs Administrations is not always guaranteed by the highest technology costs or by the most popular or famous technological brands and/or the information volume in robust data bases. The comprehensive concepts behind the business model itself, an organizational structure which adjusts to the model, interaction with qualified staff in all fields of knowledge and reasonable compliance with open standards, far from purely commercial interests, are, instead, highly determining factors behind the adequacy of the technology supporting risk management strategies.

Case study

Topic 3.2

THE USE OF TECHNOLOGY: INFORMATION SYSTEMS AND DATABASES

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CONTENTS: *Abstract.- 1. Introduction.- 2. What is risk analysis?.- 2.1. Notion of risk analysis.2.2. Areas of application.- 2.3. Methodology and supporting technological tools.- 3. The experience of the Italian Tax Administration.- 3.1. The Revenue Agency.- 3.2. The Customs Agency.- 4. Conclusions*

ABSTRACT

Our presentation shall set forth the ICT methodologies and instruments adopted by the Italian Tax Administration for risk analysis and risk management.

The topic is based on the notion of risk and the description of the instruments available for risk management. Such arguments are analyzed with regards to the needs of the Tax Administration and the critical phenomena such as tax evasion, tax avoidance, tax fraud, counterfeiting, illicit goods traffic, etc. It is worth highlighting that reliable methods and instruments to process the tax information available to the Tax Administration, as well as any other external information, enable to focus controls on subjects in an actual risk situation.

We then analyze the potential methodological and technological solutions that enable the creation of a knowledge base to identify risk situations and behaviors. While we set forth the decisions made by the Italian Tax Administration in this regard, we describe the experiences of the Revenue Agency and the Customs Agency. A description is provided of the analytical instruments developed in the past few years in the face of risks tied to the behavior of taxpayers and foreign trade,

with a brief reference to the most significant IT systems used by the Agencies to select audit targets.

We highlight the progressive improvement of the risk management instruments used by the Italian Tax Administration in order to create control strategies aimed at the actual risk areas. The outcome is increased control efficacy and a potential deterrence effect vis-à-vis future illegal behavior, while the growth of tax compliance may be deemed its ultimate goal.

1. INTRODUCTION

Taxpayers' control activity is the main axis for the Tax Administration strategies. The need to secure effective and profitable controls determined the pursuit of action modalities that enable to focus on the risk of taxpayers becoming evaders and the possibility of tax fraud.

In this regard, resorting to procedures and tools to facilitate compliance with tax obligations noticeably reduced the financial structures' focus on tax collection, allowing them to shift to taxpayers' assistance and controlling the appropriate enforcement of tax legislation.

Especially, the control strategies adopted by the Italian Tax Administration followed a dynamic path, which is still evolving and refers to the organizational structure as well as the operating and methodological instruments in aid of the auditing activities. In this regard, the risk analysis methodologies have become very relevant. Therefore, we have incorporated the tools offered by information technologies that enable a fast and effective selection of the taxpayers to be subject to control.

Based on such assumptions, this document intends to inform on the Italian Tax Administration experience vis-à-vis the risk identification and risk management procedures, especially as regards the technological instruments and solutions adopted.

For such purpose, this presentation has been organized according to two key axes: firstly, it presents the notion, the scope and the risk management solutions by the Tax Administration; secondly, it describes the Italian experience with regards to the methodological approach and the technological instruments especially adopted by the Revenue Agency and the Customs Agency to develop control activities. We also draw a number of conclusions.

The objective is to prove the progress made by the Italian Tax Administration as regards risk management based on the use of increasingly sophisticated technological instruments, considering the new control demands imposed by economic globalization.

2. WHAT IS RISK ANALYSIS?

2.1 Notion of risk analysis

Risk is the probability of occurrence of a certain event deemed dangerous. In turn, risk management is the set of instruments, methods and actions by which risk is measured and calculated and the management strategies are developed. Risk management is articulated according to three main stages: **context definition**, that is to say, the analysis scope of the potentially dangerous phenomena, indicating the type of damages and the potential actions to prevent them. In the following stage, **risk assessment**, we study the magnitude of risky situations and analyze the frequency of occurrence thereof. Finally, we **define and apply the action and monitoring plan**, by which we analyze the evolution of the phenomena observed and project other intervention modalities.

2.2 Areas of application

In the sphere of the Tax Administration, the objective of the foregoing process is to manage critical phenomena, such as tax evasion, tax avoidance, tax fraud, counterfeiting, traffic of illegal goods, etc., and it is attained by means of an appropriate control operation.

As regards taxpayers, this operation refers to the appropriate compliance of the tax obligations (tax statements and tax payment). Vis-á-vis the subjects that perform foreign trade, the control is extended to the customs operator's performance and the appropriate execution of his operations.

The analysis of tax data generated by the operative activities and the contents in the Tax Administration records is geared at identifying traditional as well as new dangerous behaviors. The critical areas are identified according to the eventual diversions from the pre-established parameters. The risk profile is built by analyzing the relevant tax features of the controlled subject.

In this context, the key aspects to consider are those tied to the taxpayer's legal nature (whether an individual, corporation, non-commercial entity, etc.), the type of tax statement filed, the sector of economic activity involved, the geographic location, the dimension (expressed in terms of income, business volume, etc.). In the case of commercial exchange (imports and exports) the type of goods, the product origin and the operator's reliability, are also important.

2.3 Methodology and supporting technological tools

In order to coordinate the management of the foregoing phenomena and concentrate controls on the risk behaviors, we must rely on a database containing all the elements required to define risk profiles. This database shall be permanently updated and improved in the light of the outcome of the controls performed and the new information gathered on risk behaviors.

In this context, two aspects of risk management become particularly relevant. On the one hand, the **quantitative approach** in the assessment of risk, which is conducted by building an appropriate database on which the corresponding statistical techniques shall be applied thereafter. On the other, the **dynamic/permanent approach** of the risk management program, which is based on a dynamic and updatable database employing browsers that adjust to the different control demands, supplied and developed by a permanent feedback system.

Relational databases, especially, the data warehouse applications, are presented as instruments to be adopted for risk management, since they guarantee the quality of data, the security and adaptability of applications. They provide effective multidimensional browsing instruments and enable the user to submit information requests dynamic and intuitively according to the specific analysis requirements. These tools enable to rely on data with different levels of detail, becoming ancillary elements for decision-making as regards tax policies and auditing strategies.

Applications are developed according to a process that arises from the definition of the objective to be analyzed. Subsequently, we proceed to identify the data sources. In the pre-processing or screening stage in which an explorative analysis, selection, transformation and formatting are performed, the data are processed in order to render the desired information. Subsequently, we draft the data mining model to shape

the knowledge base. Finally, we proceed to the interpretation and assessment of the outcomes obtained.

In this process, the implementation of applications entails an ongoing commitment as regards the data quality and the processing of the information that will support the decisions for specific objectives. Data quality is one of the requirements to ensure process efficiency.

Data quality constitutes a multi-dimensional notion that combines subjective elements, such as users' conviction that the information available is reliable and easy to use, and objectives, such as data integrity and access confidentiality.

In the light of the above, we may assert that with an appropriate organization of the processes, data quality shifts from a context-dependent variable to assuming the role of the process product proper.

The need to rely on quality data is accompanied by an equivalent requirement to guarantee data security. Therefore, the applications on which risk management is based employ a dedicated software that serves the specific requirements of the complexity of rules to allocate passwords, personalized user profiles according to the different types of subjects authorized, the request for authorization subject to approval by the responsible authority, and the complete traceability of the transactions overall, by internal as well as external users.

The applications whose structural and functional features have been just described are developed according to a knowledge-value pyramid, which represents the evolution of the elementary and non-differentiated data into information (and, therefore, knowledge), which enables informed decision-making.

Exploring tax-relevant variables (income, taxes, deductible and deducted levies, profits, value added, tax payments' flows, etc.) may be based on territorial jurisdictions (region, province, municipality, country of origin of the goods), reference terms (historic series), individual taxes, type and taxpayer and/or economic operator type and legal nature (pursuant to records, level and type of income, imports/exports transactions).

Therefore, such applications become a vital source of help to formulate the control activities' strategies and enable to assess the Tax

Administration's information basis and that of the subjects interacting therewith. Appropriate processing and crossing of elementary data enable to analyze individual phenomena and behaviors in specific contexts of reference and with different levels of detail.

Overall, building supporting technological tools for risk management is vital to the assessment of all the data available to the Tax Administration, since they enable short-term detection of the phenomena that may generate risk and elaboration of the best strategies to counter them effectively.

3. THE EXPERIENCE OF THE ITALIAN TAX ADMINISTRATION

As we mentioned before, risk analysis and risk management constitute fundamental tools in planning the auditing activity. Selecting subjects that shall be subject to audits is performed according to the assessment of the degree of risk that each one of them may pose. Such selection is articulated in consecutive phases, which range from general observation of the activities undertaken by the subject analyzed to each one of the economic transactions performed, identifying, on the basis of the information available, the indicators that may reveal the risk of violations of tax regulations or fraud. The ultimate end is to reach the greatest control efficacy and a better allocation of resources.

According to this end, different sectors of the Italian Tax Administration have adjusted a series of technological tools that, by means of processing the data contained in the supporting records of the operating activities, enable to identify, assess, and monitor risk areas.

On the other hand, in the last few years, we have added large volumes of external data referred electronically to the Tax Administration information systems to the internal data from tax statements, the registered documents and the withholding agents' statements, as well as foreign trade.

Therefore, it became necessary to deepen and strengthen the analysis of this volume of data, in quantitative as well as qualitative terms, and develop IT tools such as data warehouse and data mining), which cross data and integrate databases to enable to retrieve the audit information required.

The process to gather such information (tax and other) has been almost completely automated and centralized with the support of the

technological partner So.Ge.I. (Società Generale d'Informatica S.p.A.), a corporation 100% owned by the Ministry of Economy and Finance.

3.1 The Revenue Agency

We shall now analyze in more detail the initiatives undertaken by the Financial Administration. In the last few years, the Revenue Agency has invested human and financial resources to update and rationalize the central and ancillary systems. Its offices have been furnished with state-of-the art technological infrastructure to ensure a high level of data security and protection. On the other hand, we have strengthened the procedures and the systems employed for audits by incorporating more stringent measures to counter tax evasion, such as studies by sector. Last, but not least, we have updated the IT systems and, moreover, pursued the integration of internal and external databases.

With regards to this last point, it is worth highlighting that the IT heritage of the Revenue Agency comes largely from external sources. Recently, different provisions have set forth the requirement that certain type of information be forwarded to the Agency (especially by banks and insurance companies). Other data have been gathered according to agreements with different types of subjects and institutions (such as pension entities). Among the most useful elements of information, we may mention contracts and financial transactions, pension contributions made to pension entities, the contracts subscribed with utilities, etc.; authorizations and licenses extended by public institutions, information referred to the ownership of real estate property, vessels, motor vehicles, aircraft, etc.

The type of information briefly enumerated above converges with the internal information arising from tax management to identify the cases of tax evasion risk, tax avoidance or tax fraud, moreover as regards VAT, even at the community and international level. The means to achieve this objective are dedicated IT tools, extremely flexible, which apply data-crossing and processing criteria with regards to the context in which they shall be employed.

Particularly, the Agency developed the Web portal named F.I.S.C.O (Funzioni Integrate di Supporto ai Controlli) that integrates the functions of data searches and management in each one of the stages of the control activities. The theme areas available on the portal for queries and processing are: objectives' planning, selection for auditing purposes; controls' programming; formal and substantial

control of tax statuses; assessment of evaded taxes; payments and delinquent taxpayers' records and the collection process; monitoring. The applications developed are supported by historic files with the purpose of creating lists of subjects to be controlled on the grounds they feature risk elements. The names selected are then looked up in the Tax Record (a database that receives and processes the tax data of Italian taxpayers) to verify and update personal data.

Among the applications that may be accessed, we may mention:

- **APP.L.E (Applicazione per la Lotta all'Evasione),** which handles the information submitted by the individuals of age who carry a tax code. The user may select the subjects in its jurisdiction and according to the pertinent fiscal year, cross the information based on a feature, such as the VAT number, a certain type of income on the statement for any given year (such as no real estate property in 2005), the overall income amount (such as, for example, Euros 0 to 5,000), real estate property and taxable income; etc. This application is also frequently employed to assess the individual's taxpaying capacity according to their expenditure (the so-called "*redditometro*"). This application is available not only for the central structure that coordinates and heads the Agency's audits but also for the local units that access it to select the subjects to be audited in their jurisdiction.

- **RADAR (Ricerca e analisi decisionale per l'Accertamento del Reddito):** a data warehouse offering lists of businesses and individual businessmen based on the tax, social security, economic and structural information. The search criterion is based on the VAT number. A number of filters may be applied to reduce the number of subjects and identify those that feature suspicious characteristics.

- **MERCE (Monitoraggio e Rappresentazione Commercio Estero):** a data warehouse developed and maintained by the Customs Agency. It includes all the data refereed to trade within and outside of the EU. The M.E.R.C.E. enables to analyze the transactions of goods performed by Italian operators from and towards the EU member-states or towards other non-member states and obtain a list with all the transactions conducted by a taxpayer.

- **BDI (Banca dati integrata):** enables to select and control the taxpayers who have moved their tax domicile to countries with

preferential tax regimes. It relates personal data of these subjects to the activities undertaken or to be recorded in Italy.

- **Risk events – Preventive notifications:** they analyze subjects when they initiate their activity as a business or as self-employed individuals, individually or collectively, detecting the discrepancies or irregularities detected in the first years of activity based on the information submitted to the Tax Record. The purpose is to especially identify the transactions deemed dangerous performed by such subjects in the first 36 months of business. On the other hand, and with regards to the such subjects, we detect eventual ties to individuals and corporations that have incurred in violations in the past or may have featured suspicious characteristics or risk behaviors.

- **Risk analysis based on the VAT-ID number:** it undertakes automated controls based on information of different nature referred to the status of the subjects who, in their capacity of owners or legal agents, request a VAT number. By assigning a specific score to each piece of data, an overall danger value is assigned that enables to identify the risk VAT numbers.

- **Real estate databases – Real estate market observatory:** it is an application that assists local offices in the control of title deeds for the purchase-sale of real estate property. It is aimed at enabling the crossing of information on the title deeds and the real estate property originating it, along with the reference values taken from the Real Estate Market Observatory (OMI, as per the Italian acronym). This procedure enables the units, in the framework of their control activities, to assess the status of all the parties to the title deed (the assignor, the assignee, the notary public and the broker).

The applications we have just briefly addressed are available to all the staff in charge of the control activities.
Other procedures in support of risk analysis are exclusive for certain subjects, which may even not form part of the financial Administration (such as, The Finance Committee and the Budget and Studies Services of the House of Representatives and the Senate, the National Statistics' Institute and the National Social Security Institute). These are ancillary instruments for senior management to make decisions regarding tax and audits' policies. We may mention among them:

- A query and reporting Web application based on the data from the tax statements of individuals, partnerships, corporations and non-commercial entities. A guided questionnaire based on pre-filled data enables to summarize the current tax dimensions on the tax statements by means of statistical outputs (frequencies, amounts, averages, etc.) presented as tables and graphics. The applications integrate a hundred variables and enable to relate the data in specialized files in order to obtain the information indicating potentially critical situations.

- An application that enables to graphically analyze the ties existing among subjects and businesses (or among businesses) and browse through the data to detect relations of eventual ties between subjects and corporations that, at a first glance, seem to be unrelated.

As regards management of internal risks, that is to say the possibility that the structures or staff may present inappropriate or even illegal behavior, we have created a supporting IT system for the internal auditing activities that, in addition to assisting in managing the planning and performance of activities, generate a risk map of the business articulated by risk type.

The procedure feeds a data warehouse containing the outcomes of all the national auditing activities. A query and information platform provides a summary of all the information required for the overall activities' coordination, defining the general risk status framework for the different units.

3.2 The Customs Agency

The mission of the Customs Agency in the context of economic globalization is aimed at, on the one hand, protecting the market and consumers, as well as collecting at the EU as well as national level; on the other, at facilitating trade in favor of the operators that act according to the law and promoting competitiveness among businesses. Therefore, the Agency's control activities shall strike a balance between effectively preventing tax evasion, tax fraud and illicit traffic and the flow of trade.

On this basis, it developed the Customs Agency risk management system. The Agency created methods and procedures to guide the controls to prevent actual risk situations, enabling operators who act within the law to perform their economic activities unhindered.

Based on this criterion, the Agency undertook a deep review of their information systems in the last few years. In order to simplify and expedite customs formalities, processes have been redesigned to adjust to the opportunities of digital technologies and live up to the demands of processes' integration by other entities who also participate in customs activities.

Building the current customs IT system (AIDA – Automazione integrata Dogane e Accise) is the result of a simultaneous digitization and reengineering of the service-rendering processes and the related activities to adjust them to the demands and simplification possibilities offered by ICTs.

The strengthening of the risk analysis instruments which have been integrated into the new system is also part of this renewal. The Customs Control Circuit procedure includes three types of risk profiles:

- Specific, or developed based on parameters defined by the risk analysis;
- Mandatory, that is to say, defined by law;
- Occasional, that is to say, purely random.

Profiles may be **objective** with regards to the type of goods, the advantageous or restrictive measures on the goods and duties. Likewise, they may be subjective, with regards to the operator, its legal nature, the transaction performed and the traffic of goods. These profiles are jointly assessed with other elements, such as the manipulation of sensitive products or concealed goods.

The risk profiles are drafted according to the analysis of all the possible sources of information. The elements may arise from the communications foreseen for the procedures within the EU, or otherwise, from the Units of the Agency. Also employed are the surveys and data on commercial flows and potential distortions originated by other public administration sectors and/or the EU and international agencies. The modifications in the customs naming standards also contribute to the development of the profiles, as well as the outcomes of audits, performed at the time of clearing the goods as well as those conducted later with the operator. The process is completed with the analysis and the information of businesses with regards to their activity, structure, internal organization, variation in the business volume, change of venue, etc., obtained through the Tax Record and the Customs data warehouse.

From the operational standpoint, the Circuit is automated. Upon receiving the customs statement that the operator submits at the time of clearing the goods, the circuit directs it towards four control channels (green, yellow, orange, red), which are tied to the risk profiles that arise from a combination of the elements in the statement (origin, type of goods, type of operator and/or operation, etc.). The meaning of the colors is tied to the type of control defined by the system according to the risk profiles of the transaction to be performed.

Customs Control Circuit

GREEN = No control, since no risk profiles are detected (defined as automated control, that is to say, already performed by the system proper).

YELLOW = Control of the documentation attached to the goods.

ORANGE= Control with a Scanner.

RED = Physical inspection of the goods.

The subjective profiles regarding the operator and their reliability reduce or increase the risk, and therefore, the level of incidence of the controls. For such purpose, the EU provisions foresee granting a reliability certificate (Authorized Economic Operator - AEO) once the national customs authority in charge of controlling operators verifies that the operator meets the professional compliance requirements defined by the member countries. Extending the AEO status entails a personalized control degree which reduces the degree of risk posed by the operator.

In the last few years, the customs risk analysis system has been reinforced with new instruments, which were added to counter illegal and dangerous traffic (for example, weapons, drugs, illegal immigration) and the trade in forged goods (protecting the notion of “Made in Italy”).

We shall now refer to the type of control foreseen by the orange color, which channels the goods towards the **scanner**. This instrument enables to view a type of x-ray of the inside of the container or the trailers of trucks. There are 28 scanners, which are connected in a network, located in the main national ports and interports that enable the analysis of the transportation means in a non-invasive fashion. Controls may be in-depth or determine a new control (such as, the physical inspection of the goods). The images obtained with the

scanner are forwarded to the MATRIX command center to feed an image database of reference, employed to adjust and facilitate the analysis of the successive scanned images. The outcome of the control proceeding is forwarded to the customs control Circuit and contributes to risk analysis.

Traffic of forged goods has been added as a new element of risk in trade. In order to combat this phenomenon, we have developed a procedure by the name of FALSTAFF (Fully Automated Logical System Against Fraud and Counterfeiting), which has been built on a multimedia database that is fed electronically by the same operators that file the request for trademark protection, pursuant to the EU provisions on the matter (Council Regulation 1383/2003). A spreadsheet is created by company with files for each one of the products requiring protection. Once the files are entered into the system, it will enable to recognize the original products and identify counterfeiting and fraud in subsequent controls. The information gathered with FALSTAFF integrates the risk profiles employed in the automated selection of the goods to be subject to control.

This articulated system, adopted by the Italian Customs Administration, foresees a phase of monitoring the risk management process and profile adjustment. A unit of the Agency conducts an ongoing analysis of the feedback from the controls performed, updating the risk profiles entered in the customs control circuit. Precisely by reading the specific electronic message on the control outcomes, the system is enabled to immediately recognize the eventual irregularities detected, the type of violation, and all the other elements referred to the customs statement and audit. Therefore, the overall outcomes of the controls enable to undertake a timely dynamic system adjustment, in other words, assess the efficacy of each risk profile, modifying or adapting it, and the general review of the risk management process in order to sustain the system efficiency and efficacy.

4. CONCLUSIONS

We have briefly presented a number of the technological solutions adopted by the Italian Tax Administration to address the issues inherent in risk management. The applications are the result of a long process to adjust the risk analysis methodologies and the subsequent adoption of the supporting technological tools. The experience enables to identify two main development branches.

Firstly, as regards gathering and managing the information required in the tax assessment, we have strengthened the cooperation with third-parties to access the information that was unavailable to the Tax Administration in the past, even when such information was vital to draw the general framework of economic activities relevant for tax purposes. Data converged in databases whose use is in constant evolution and should enable the development of increasingly sophisticated intelligent search tools.

Secondly, from the standpoint of the control strategies, the Tax Administration proceeded to organize in an increasingly systematic fashion the information it held to transform an indiscriminate volume of data into instruments to identify the phenomena requiring controls and actions. Such strategies contribute to the risk analysis methodologies that are, in turn, supported by increasingly more relevant and articulate technological knowledge and risk management tools.

This outlook, although limited only to the technological criteria and instruments adopted for risk management purposes, evidences that the Italian Tax Administration has become gradually aware of the relevance of the specific strategies in this field to articulate the control activities in risk areas, not only to counter evasion, but also to prevent it, since the efficacy of controls and outcomes in terms of effectiveness (as regards determining the existence of risk) and profitability (measuring the degree of risk) constitute a deterrence element for future irregular behaviors. In fact, it is reasonable to think that if taxpayers and economic operators perceive the Tax Administration's capacity of being informed on their overall tax-relevant activities, identifying and punishing their activities marked by a higher risk, they shall correct and/or adjust their behavior.

In order to conclude, risk management pertains to the context of improvements in the Tax Administration's performance, with a view to strengthening tax compliance, pursued, on the one hand, by supplying better taxpayer services, and on the other, just as we set forth in this presentation, by the progressive efficacy enhancement and timely control.

Case study

Topic 3.3

ORGANIZATION AND DEVELOPMENT OF TAX INTELLIGENCE ACTIONS AND ALLIANCES WITH OTHER GOVERNMENT AGENCIES

Raelene Vivian
Deputy Commissioner of Taxation
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(Australia)

CONTENTS: 1. How the Australian Taxation Office builds intelligence systems and works with other agencies on cross-agency anti crime work.- 2. ATO's compliance model.- 3. ATO compliance strategy and effectiveness.- 4. Our risk management framework.- 5. Building an intelligence capability.- 6. What is intelligence?.- 7. Cross agency liaison to deal effectively with crimes affecting tax administration.- 8. Case study: project WICKENBY cross agency taskforce. 9. Conclusion

1. HOW THE AUSTRALIAN TAXATION OFFICE BUILDS INTELLIGENCE SYSTEMS AND WORKS WITH OTHER AGENCIES ON CROSS-AGENCY ANTI CRIME WORK

In Australia, tax risk management is a core issue for both taxpayers and the community because tax impacts on all Australians, directly or indirectly.

In the Australian context, our view is that voluntary compliance is the most critical element. Everything we do is done in a way that builds community confidence and hence voluntary compliance. We do this by using a risk management approach, guided very much by our Compliance Model1. Intelligence provides us with the understanding required to make informed decisions about what our risks are and how best to respond, ideally before the event. Intelligence also contributes to measuring the effectiveness of these risk strategies.

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[1] *Compliance Model*

This paper will describe some of the contextual underpinning building blocks of the administration of the Australian Taxation system such as the ATO's approach to risk management and how we are building and using intelligence systems to inform risk management strategies and compliance effectiveness. Discussion will then centre on how specialist skills have been brought together to establish a corporate risk and intelligence area focussed on building an intelligence capability. Through an operational case study the paper will then discuss the lessons learned in building close alliances with other government anti-crime agencies and how to work together.

This paper is structured in five parts around:

- ATO Compliance Model
- Compliance Strategy and Effectiveness
- Risk Management Framework
- Building an Intelligence Capability, and
- Cross agency liaison to deal effectively with crimes affecting tax administration.

An important resource should you want to know more detail on any of these topics is to go to our web site – www.ato.gov.au.

2. ATO'S COMPLIANCE MODEL

The ATO's Compliance Model is a regulatory pyramid which seeks to encourage as many taxpayers as possible to the base of the pyramid where there is self regulation and high levels of voluntary compliance. This contrasts with the narrower apex which is characterised by a wilful minority who seek to abuse Australia's tax and superannuation systems.

The ombudsman, who is an umpire of administrative review for a range of Australian Government agency decisions, has observed that:

'In a self-assessment environment, voluntary compliance is a vital component. While this depends in part on the taxpaying community having confidence in the ATO, it also rests in large measure upon the taxpaying community being aware of its obligations, and deciding to engage in a lawful, ethical and compliant behaviour. In my view, education and deterrence by the ATO have significant roles in facilitating such outcomes.' [2]

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[2] *Commonwealth Ombudsman submission to Joint Committee of Public Accounts and Audit (JCPAA) Report 410, p5.*

The importance of an effective deterrence was recently commented upon by a parliamentary enquiry committee - the Joint Committee of Public Accounts and Audit (JCPAA) in its Report 410:

'However, the prevention of aggressive tax planning in the future is less likely to depend on legislation. As the history of these investments show, the legislative response takes a number of years. Rather, it is more likely to depend on the ATO's data collection, analysis, risk management, initiative and the quality of staff. Although such preventative work is unlikely to attract much public recognition, it is an important factor in the integrity of the tax system.' [3]

The ATO's Compliance Model requires us to understand the causes for non-compliance and to develop responses that are directed at remedying the causes, whether they are lack of information, practical difficulties in complying, or game-playing and wilful non-compliance.

As an Australian Government agency, we are also required to comply with various statutory obligations[4] and government guidelines which require sound risk management[5] and ultimately an assurance to the government of the day by the Commissioner that he operates efficiently and effectively.

So both practical and legal requirements coalesce to ensure that risk management in the broader sense is ingrained in the culture of the ATO. In this way the Compliance Model is a key instrument in the ATO's approach to risk management.

We undertake risk assessment of events and their causes, and then consider the effectiveness of our controls and mitigation strategies. In other words we focus on the cause of the non-compliance rather than the symptoms.

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[3] *JCPAA Report No 410, June 2008, p18. The JCPAA also referred to the ANAO's 'The Australian Taxation Office's use of Data Matching and Analytics in Tax Administration', Audit Report No 30 2007-08, 24 April 2008 for an update on the ATO's use of data matching.*

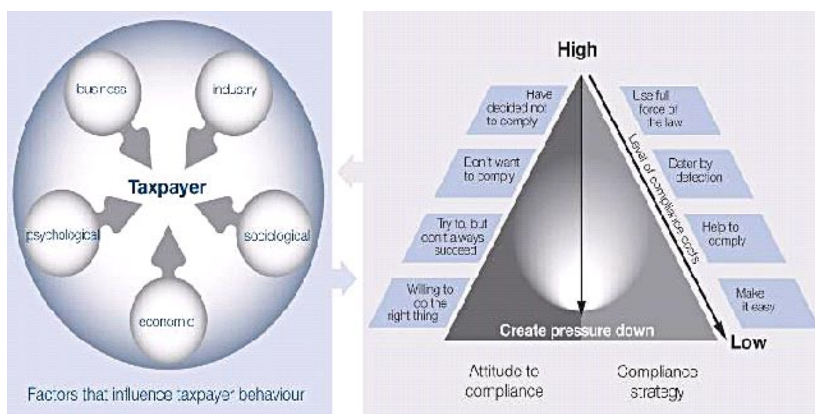
[4] *Examples include the Financial Management and Accountability Act 1997, the Occupational Health and Safety Act 1991 & the Safety, Rehabilitation and Compensation Act 1988.*

[5] *Risk Management Standard (AS/NZS 4360:2004) & OECD Guidance Note on Compliance Risk Management.*

The ATO's key risks are captured in our risk and priority statements that form the basis of our corporate planning. Many of our activities are responses to risks that we are actively monitoring and reviewing through our corporate governance process.

The ATO is not resourced to chase every last tax dollar - and in any event this would be a very simplistic approach that would impose significant dead weight compliance costs on the Australian economy. Rather, we adopt a more holistic approach that seeks to address the causes for non-compliance with appropriate responses. This requires us to ask the right questions, identify the entities and events that have a significant impact on the proper operation of the laws we administer and the reasons for that impact, and to tailor our responses accordingly.

COMPLIANCE MODEL



3. ATO COMPLIANCE STRATEGY AND EFFECTIVENESS

The ATO has developed strategies to promote voluntary compliance and build confidence in the taxation system. The Compliance Model looks at the factors that influence taxpayer compliance and their underlying attitude to compliance – information about their business, industry they work in, along with sociological, economic and psychological considerations. The model is used to assist in understanding taxpayer behaviour and in deciding the most appropriate compliance strategy to utilise in respect of the particular behaviour, taking into account the individual circumstances of the taxpayer.

Another aspect to our compliance strategies involves dealing with tax crime (or rather, crime affecting tax administration). There are a number of identified areas where serious and organised crime has an affect on tax administration. The key aim for the ATO is to protect the revenue and integrity of the tax system and to support whole of government strategies to detect, deter and deal with serious and organised crime.

Ensuring that our compliance strategies are effective in achieving the ATO intent is very important. We need to know whether we have had a positive and sustainable impact on compliance behaviours and community confidence. Whilst we have some effectiveness measures they are generally relatively low level and provide minimal insight into the improvement impact on voluntary compliance. We are in the process of developing substantially better measures of our effectiveness. An important element of this methodology is the appropriate intelligence to provide the data to inform the effectiveness indicators.

At a compliance risk level, our effectiveness methodology[6] is a tool to assist in both planning for our compliance strategies to be effective and measuring how effective they are, measuring the extent to which our compliance strategies are achieving our business intent of optimising voluntary compliance and building community confidence which will enable us to demonstrate that we are providing value for money to our ATO executive, the government and the community.

Applying the methodology to compliance risks helps us to identify:

- the right mix of compliance strategies relative to the level of risk and the available resources
- whether there are positive, sustained changes in taxpayer behaviour and community confidence as a result of our compliance strategies
- whether compliance strategies are effective in the immediate target groups and whether they have had a ripple effect on surrounding groups and beyond to the broader taxpayer population, and
- the rate at which compliance strategies are having an effect on voluntary compliance and community confidence.

[6] *'Measuring compliance effectiveness – applying our methodology' Nat 72342-08.2008.*

The methodology involves working through four interdependent and iterative phases as follows:

Phase 1: Ensures that the compliance risk is stated in terms of the risk to achieving
the ATO business intent. For instance, that the risk is aligned to our business intent and adequately reflects the behaviours and their drivers, and that the risk is refined, concise and not open to interpretation.

Phase 2: Ensures that the outcomes and strategies are defined in measurable terms so that:

- the desired outcomes align to business intent and the risk identified
- the overall desired outcomes are adequately covered by specific success goals
- the strategies target participants of the risk and drivers of the behaviour, and
- the strategies address any unintended consequences.

Phase 3: This phase designs a range of potential effectiveness indicators and applies a series of business validation tests to ensure that they are viable. This phase ensures that each success goal can be measured and has a corresponding indicator, and that indicators are viable and provide a balanced picture of performance using both qualitative and quantitative information.

Phase 4: Drills into the detailed analysis to paint a defensible picture of the effectiveness of the compliance strategies. It involves the support of data and intelligence analysts and evaluation experts, who in collaboration with the risk manager will determine the evaluation approach and evaluate effectiveness, comparing actual outcomes with the desired outcomes.

4. OUR RISK MANAGEMENT FRAMEWORK

In the ATO’s view, good tax risk management requires a systematic and structured approach. Not only do we follow the principles set out in the Australian and New Zealand Risk Management standard and the 2004 OECD Guidance Note ‘Compliance Risk

Management: Managing and Improving Tax Compliance', but we also use a corporate environmental scan to identify emerging risks.

The ATO uses this framework to manage both business operating risks (e.g. OH&S, Security etc) and compliance risks. Examples of our use of risk management include how the ATO:

- administers tax law
- is run as an organisation (e.g. the health and safety of our staff, our computer systems, Security etc)
- manages our relationships with our stakeholders, and
- identifies and treats non-compliance with limited resources.

The framework assists us in prioritising our compliance work by informing decision makers about the resource commitment required. There are five key components:

- continuous monitoring of taxpayer activity
- identifying, assessing and prioritising risk
- understanding factors underlying taxpayer behaviour that drive any non-compliance
- addressing non-compliant behaviour, and
- evaluating the success of interventions.

Risk management is a critical part of how the ATO manages its business. We use the process to:

- identify unwanted and beneficial events that may occur that would potentially affect our ability to achieve our desired outcomes
- determine how those events might come about, and
- help decide which events we need to prevent or manage.

Every organisation has risks, but few, if any, have sufficient resources to eliminate all potential risks. They are caused by a wide range of factors from the differences in individuals' behaviour to natural disasters. However, some events are unlikely to occur and even if they did, the consequences would be very minor. On the other hand, some are very likely to occur and their consequences may or may not be tolerable, while others may be less likely but carry potentially catastrophic consequences. As a result, informed decisions need to be made about which risks can be tolerated and which need to be managed. This requires the ATO to be able to:

- assess the likelihood that an event will happen, both in terms of probability and frequency
- estimate the consequences should the event occur
- evaluate which of these combinations of likelihood and consequence are not tolerable (these are the risks we will need to manage in some way)
- understand how and why the intolerable events would/have come about, and
- develop and implement strategies to manage the likelihood and consequence of these events to tolerable levels.

Effectively managing our risks ensures that we achieve maximum voluntary compliance from an Australian community that has confidence in their tax system. It ensures that we provide a value for money service and are able to report to government effectively.

5. BUILDING AN INTELLIGENCE CAPABILITY

Intelligence and risk management are separate but closely aligned capabilities. Intelligence provides us with the understanding required to make informed decisions about what our risks are and how they need to be managed. Intelligence contributes to good risk management by assisting us to identify the causes of unwanted and beneficial events, which allows us to better measure their likelihood and consequence. The ultimate purpose of an intelligence function is to provide decision makers with the information to enable them to make informed decisions.

Within the compliance context we carry out a range of intelligence activities to support effective management of compliance risks. We do this at three levels:

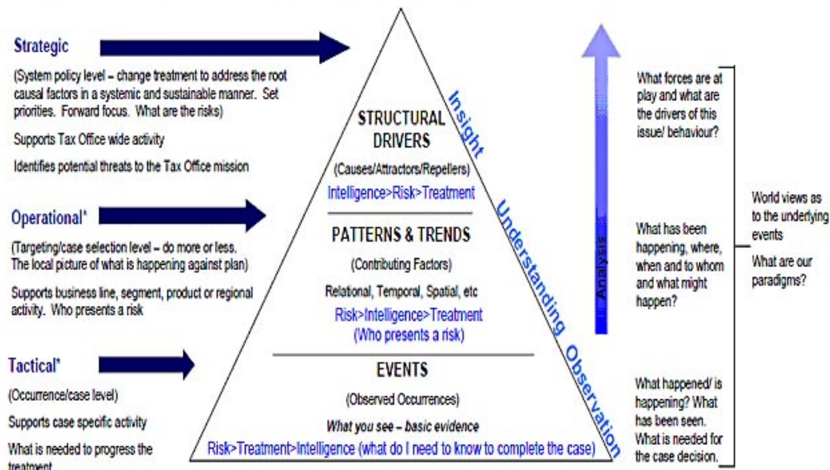
- at the strategic level we focus on identifying and reporting on vulnerabilities and shifts in the tax system and how they are, or may be, exploited. We are using this to understand and report on the causal factors and drivers of non-compliance in our area of interest and the effectiveness of treatment strategies. Activities we undertake include ongoing monitoring of domestic trends, patterns and developments across the broad environment of economic, social, political, legal and ecological factors. Our horizon is not limited to the next 12

months but extends to the five year plus outlook

- in parallel with this, at an operational level we look to derive indicators of non-compliance that can be used to identify cases in our area of interest so that we can apply relevant treatment strategies. Our analysis of past taxpayer performance and behaviour allows us to identify trends and patterns that might lead to new risks or change our assessment of current risks, and
- thirdly, the priority of effort is focused on understanding the nature of those risks that we have assessed in how they need to be managed. This goes beyond merely identifying trends and developments to developing an understanding of the underlying factors and drivers associated with the risk. Such an understanding allows us to make more informed decision about how to best treat each risk, and where to target our treatments. In addition to identifying who needs treatment (from a compliance perspective) it enables us to prioritise candidates so that we get maximum benefit from limited compliance resources.

6. WHAT IS INTELLIGENCE?

STRATEGIC INTELLIGENCE	Provides senior decision makers with insight or understanding, and aims to make a contribution to broad strategies and policy
OPERATIONAL INTELLIGENCE	Supports decision makers at all levels in planning, resource deployment and case selection activities
TACTICAL INTELLIGENCE	Supports decision makers in taking case specific action



Reference
Enhanced from page 102, Strategic thinking in criminal intelligence, Jerry H Ratcliffe – Editor, Federation Press

The purposeful development of the ATO's intelligence capability has been occurring over a number of years. Before 2003, intelligence and risk identification in the ATO was not systemically synthesised at the strategic level. There were pockets of good work in intelligence and risk identification being conducted in the ATO. However, formal training and analysis skills tended to be ad hoc. Effective systems and networks operated at a tactical and operational level. The intelligence function operated in relative isolation, and in general there were limited formal networks for the exchange of intelligence between areas, and the wider ATO community. This approach resulted in reliance on informal networks which, while effective in isolation, did not facilitate the delivery of strategic intelligence to the ATO executive.

The disparate intelligence functions produced an environment where an 'intelligence failure' could potentially occur. Such failures historically occur when the intelligence function is scattered, with little or no formal procedures in place to ensure the production and dissemination of accurate and timely intelligence.

In 2004, the ATO executive commenced to address this perceived weakness in our strategic capability. The diverse nature of the ATO's work and client base meant that 'one size' in intelligence terms did not 'fit all'. Intelligence units needed to be appropriately tailored to the sources of intelligence, the decision making requirements and the local environment. There needed to be a requisite level of diversity at a tactical and operational level balanced with the ability to synthesise a strategic or corporate view of intelligence. It was critical that the ATO's intelligence capability focused on strategic risk areas and on sensing emerging strategic threats.

In June 2005, an Intelligence and Risk capability strategy was endorsed which set out a strategic leverage model for delivering intelligence outputs for the ATO. The model also aimed at building stronger and more professional intelligence and risk capability across the office.

The ATO's intelligence system can be thought of as a federated or hub-and-spoke intelligence model. Each of the business areas responsible for compliance have their own intelligence resources that focus on their respective intelligence needs, particularly at the operational and tactical level. These units provide the spokes of the model. The hub is provided by the Corporate Intelligence and Risk Unit, which engages with all business areas to facilitate sharing the intelligence across business areas from a strategic perspective.

In 2005, we estimated it would take approximately 5 years to evolve to a more mature intelligence system. Progress whilst initially slow has now developed good momentum towards a more robust intelligence capability.

Three focus areas have provided this momentum:

1. capability building blocks
2. establishment of a Corporate Intelligence and Risk Unit, and
3. establishment of a Corporate Intelligence and Risk Leadership Group.

1. Capability building blocks

From a capability development perspective, the ATO is investing in four capability building blocks:

- **Culture:** the ATO is evolving to an intelligence led organisation where intelligence is used to help us identify and evaluate our risks. This includes creating a culture where the collection and analysis of information is driven by decision makers' knowledge needs.

- **Workforce skilling:** while the ATO has traditionally had many excellent analysts and technical experts, they have generally not had any particular training in intelligence or risk management. We have begun to roll out a skilling program that will complement analysts existing skills and knowledge with skill in the areas of:
  - intelligence theory and tradecraft
  - intelligence process
  - critical thinking, and
  - analytical techniques.

Processes: we have adopted an intelligence framework to improve coordination of our intelligence activities and ensure a consistent approach, whilst ensuring sufficient flexibility to accommodate the office's varying intelligence needs. This includes constant processes and mandated systems where appropriate, but allows tailored approaches to sources, collection and analytical methodologies.

- **Technology:** here again the focus has been on a common framework which allows a degree of flexibility. This includes a mix of common enterprise level systems and tools complemented with business area specific tools.

Another significant project being undertaken to enhance the ATO's capability in this area is the Evidence, Litigation and Information Management program. This is a targeted program of people, process and technology changes to significantly enhance the ATO evidence, litigation and intelligence management capabilities, particularly for complex compliance cases, taskforces and aggressive tax planning. There are four work streams:

- o Analyst workbench – which is to improve and support the collecting, sharing and analysing of intelligence by providing systems and tools to support the gathering, consolidation, analysis and visualising of information.
- o Evidence Capture and Management – to improve the capture and management of evidence in the ATO by reducing the time taken from capture to analysis using business processes and systems that are scalable, repeatable and defensible.
- o Litigation Support – to improve the success and efficiency of ATO litigation by providing enhanced people, process and technology support for document management, collaboration, practice management and a litigation support system to enable complex cases to be managed and litigated in court using an electronic format.
- o Security - to provide appropriate security for information held by our intelligence areas and an enterprise solution for how we share and access this information.

2. Establishment of a Corporate Intelligence and Risk Unit

A specialist unit - the Corporate Intelligence and Risk Unit - was established to formalise intelligence and risk at the corporate level. This unit's role encompassed intelligence, strategic leadership, and capability development. This role is supported by collaborative relationships with the respective business area intelligence units. These business units still retained the responsibility for primary intelligence collection, evaluation and risk management, but within a broader framework of centrally managed capability and strategic assessment.

The purpose of the corporate unit is to coordinate intelligence and risk functions across the ATO and to act as the strategic level synthesis point for the organisation. There was also a need to establish realistic functional requirements to support this capability. These included skill sets and areas of expertise, systems support, realistic benchmarks and performance measures, and appropriate reporting mechanisms.

The Corporate Intelligence and Risk Unit also maintain a corporate intelligence repository for the storing and sharing of intelligence and provides capability leadership for intelligence and risk management. This includes development of process, specialist training and professional advice. The Corporate Intelligence and Risk Unit is also developing a collection and requirements management network that will ensure better visibility and coordination of intelligence activities across the ATO.

There are currently around 25 people working in this Corporate Intelligence and Risk Unit. Across the ATO there are around 550 to 600 staff who spend more than 50% of their time working in our intelligence and risk capability (representing around 6% of the compliance workforce). The Corporate Intelligence and Risk Unit has four teams focussed on:

- futures intelligence - this team prepares broad ranging synthesis of future threats and business drivers in the ATO environment focusing on key strategic inputs to the annual planning and risk process. This is achieved by providing briefings, scans, assessments and scenarios back to business areas and the ATO Executive
- strategic intelligence – this team provides the ATO Executive with a comprehensive suite of strategic intelligence products highlighting emerging trends, key issues and significant matters affecting the ATO with a specific focus on business areas
- intelligence training and development - this team develops tools, procedures and support in the capability domains of people, process and technology. Key responsibilities include procedural doctrine, training and development, and other HR strategies i.e. recruitment and retention, and
- special projects – this team has a focus on projects that facilitate people, process and technology outcomes along with sustainable improvements to strategic intelligence and risk assessment capability.

3. Establishment of a Corporate Intelligence and Risk Leadership Group

The ATO identified the need to establish a senior executive group to provide corporate leadership and strategic direction to the intelligence and risk capability. This is known as the Intelligence and Risk Leadership Group and comprises senior executive with key risk management accountabilities.

The role of the Intelligence and Risk Leadership Group is to:

- enhance, guide and influence the direction and priorities of the ATO intelligence and risk capability
- influence the intelligence and risk forward work program
- facilitate strategic level 'intelligence roundtable' discussions where intelligence information is shared and where members collaborate to solve cross business area intelligence and risk issues
- drive change in intelligence and risk practice in business areas
- develop, endorse and promote key intelligence and risk products and initiatives across the ATO, and
- act as a key reference group for major intelligence and risk projects in the ATO, providing governance bodies with assurance of compliance and endorsement of solutions.

What outcomes can be expected along the way?

While we as an organisation are only half way through our implementation, we are already seeing the benefits. The development of a centralised repository for intelligence has improved coordination and collaboration between intelligence units across the ATO. This has improved the quality of intelligence significantly.

The establishment of the Corporate Intelligence and Risk Unit and the Intelligence and Risk Leadership Group has improved cross agency/ business areas coordination, which has afforded better collaboration and reduced duplication. It has also added an extra layer of corporate strategic analysis to support our strategic business planning.

The establishment of a capability leader for intelligence has ensured a more consistent and rigorous approach to development of our intelligence and risk capabilities.

Through our greater understanding of compliance behaviours and drivers we are starting to better differentiate between unintentional or intentional non-compliant behaviour and apply the correct administrative process.

By understanding the factors that drive compliance behaviour we can then address the cause rather than the symptoms of non-compliance and develop more tailored compliance strategies and by doing so, encourage taxpayers to better comply voluntarily with their tax obligations.

In the future we expect to see:

- more effective efficiencies in intelligence and the risk identification processes
- improved standards and support
- avoidance of unnecessary duplication, and
- a corporate acceptance and understanding of the role of intelligence.

What lessons have been learned?

We are still learning as we evolve our intelligence capability. Our learning's to date are outlined under the following headings:
- overall systems
- identification of intelligence needs
- data analysis, and
- specialist staff.

Overall Systems

The best intelligence system that currently works for the ATO is a hub-and-spoke model. It allows for close working relations between intelligence teams and the business areas they support, whilst still ensuring centralised coordination and synthesis. It is based on the principle of keeping the intelligence team close to the business area that is identifying and mitigating the identified risks.
Common systems and processes allow staff to work together and share the results of analysis.

Identification of intelligence needs

Intelligence activities need to be driven by the needs of decision makers. Without a clear indication of what decision makers need to know, the intelligence system will fail to deliver or will be inefficient. This led to the development of a Strategic Key Intelligence Need framework – this results in a document that articulates and helps guide and measure the ATO's intelligence activities. The development of this documentation affords intelligence areas across the ATO visibility of what the organisation is looking for at the corporate strategic level.

This documentation provides a formal assessment of the key intelligence needs relating to the 'patch' being managed and resources available to manage it. The assessment involves a successive drill down from

the broad 'patch' success measures into finer levels of detail around key problem areas, key clients and treatment strategies that address these aspects.

The articulation of these needs and priorities will only succeed where it is closely integrated to the business planning and budgeting process.

Data Analysis

Tax administrations collect and store large volumes of data that contain many trends and patterns that are not obvious. We can discover these trends and patterns using sophisticated techniques such as data mining. Our intelligence activities need to include:

- detection of indicators associated with known risks
- testing of hypothesis developed from observations and developments
- research into known or suspected areas or interest, and
- routing analysis of data holding to discover new trends and patterns (and potential risks).

We have to balance the 'need to know' with the 'need to share'.

Specialist Staff

The production of good intelligence requires the pairing of staff with expertise in intelligence with subject matter experts supported by specialist collectors and analysts. With this in mind the ATO has developed an intelligence workforce comprised of different skill sets. These include:

- intelligence officers – officers that understand intelligence theory and process.
  This includes staff that carry out specialist collection activities, analysts and those who manage intelligence activities
- domain experts – subject matter experts who have deep knowledge of a 'patch' (market, industry etc). They bring specialist knowledge to intelligence planning, collection and analysis, and
- functional experts – officers with specialist skills such as statisticians, economists.

The compliance business areas play an important role in intelligence. Knowledge of their patch and ability to collect information of intelligence 'value-adds' to the process.

Through the design, implementation and maintaining a strong focus towards successful intelligence and risk capabilities and our ability to work with other agencies both domestically and internationally, we will be better positioned to identify current and emerging threats to the administration of the tax and superannuation systems.

7. CROSS AGENCY LIAISON TO DEAL EFFECTIVELY WITH CRIMES AFFECTING TAX ADMINISTRATION

Our Commissioner recently reflected that:

'On the compliance front, the serious risk posed by international tax schemes will keep us busy. We are expanding our work in this area, especially through stronger cooperation with other tax authorities and international jurisdictions'.

The Commissioner has also on many occasions endorsed the furtherance of multi-agency approaches, with clear fast outcomes, project management, and good governance and of course the highest levels of integrity.

Increasingly, we are operating at policy, strategic and operational levels with other agencies (the Australian Federal Police, the Australian Crime Commission, the Australian Securities and Investments Commission, the Commonwealth Director of Public Prosecutions), Australian Transaction Reports and Analysis Centre (AUSTRAC)[7] and together continue to build effective enforcement capabilities to address serious non-compliance against tax administration. Together, recognising each others' different roles and legislative frameworks we are building a more effective enforcement capability to address serious non-compliance and other activities against tax administration and financial regulation.

By working in taskforce arrangements, we are collectively able to apply a very powerful range of remedies and powers to combat fraud and evasion. For example, the police have access to surveillance and intercept powers, the Crime Commission has compulsory coercive examinations powers, the ATO has access to civil powers of audit

[7] *The Australian Transactions Reports and Analysis Centre (AUSTRAC) is Australia's anti-money laundering and counter-terrorism financing regulator and specialist financial intelligence unit. AUSTRAC was established under the Financial Transactions Reports Act 1988 (FTR Act) and is continued in existence by the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (AML/CTF Act).*

and financial penalties and the Australian Securities and Investment Commission has powers to prosecute for breaches of corporations' law.

Our strong working partnership with AUSTRAC is viewed as being crucial to our business objectives. AUSTRAC is our primary source of data on Australian taxpayers who may be engaged in tax evasion such as using tax havens. Our ability to access and share information has helped us raise income tax assessments, collect debt and, in some cases, contributed to prosecution activity.

Our access to AUSTRAC information helps build the picture of a taxpayer's financial activity. The value of AUSTRAC information in this process can vary from being the critical

piece of information highlighting either improper activity or information that validates there is no impropriety involved.

The ability of the ATO to address attacks on the revenue is highly dependent on all agencies having the collective capability to respond and collaborate. To make it work, however, takes a significant shift in agency cultures at both operational and senior management levels. People at all levels, in all agencies, have to appreciate that the traditional linear ways of managing casework may no longer be appropriate. We need to accept that there are multiple options for achieving an outcome and the most efficient and effective outcome may result from handing the case over to another agency and allowing their remedies to apply.

As fraud and evasion become more sophisticated and global our responses need to improve and grow. By working in taskforce arrangements across government we are able to apply a very powerful range of remedies and processes to combat fraud and evasion.
Our ongoing relationships with other agencies provides the ATO with crucial support in our ability to identify abusive behaviours and threats against the tax administration and collaboration on whole of government basis on more wide ranging threats that cross multiple areas such as corporate regulation and organised crime in general. It places the ATO in a position to effectively deter, detect and deal with serious threats to the taxation and superannuation systems and work to help maintain community confidence in general on a number of fronts.

The following case study on ‘Project Wickenby’ explains the ATO’s key learning on building sustainable ongoing alliances across other agencies. These learning’s are described under twelve areas:

- building executive understanding of the threat and support for a joint strategic response
- securing government support at a taskforce level
- setting up the formal infrastructure for the taskforce
- building infrastructure and capability quickly
- enhancing capabilities of our people
- influencing new approaches within agencies
- building a whole of government strategy
- influencing new approaches within agencies
- reforming administrative practice, policy and legislation
- harvesting intelligence from work
- providing catalyst for greater cooperative international approach, and
- improving community confidence.

8. CASE STUDY: PROJECT WICKENBY CROSS AGENCY TASKFORCE

Whilst there are a variety of potential areas we could focus on in this case study, we have chosen to explore and share the relationship building strategies associated with this task force as these have provided the key to achieving extensive innovation and breakthroughs.

Uncovering the threat

In 2004, at the request of the ATO, the Australian Crime Commission investigated a Switzerland based tax promoter. The investigation subsequently exposed financial arrangements that were assessed as posing a significant threat to the integrity of the Australian tax system.

Building executive understanding of the threat and support for a joint strategic response

The ATO carefully considered which other agencies may be able to help, needed to be informed early of what we had found and should be invited to work with us at an early stage. Relationships between agencies at the early stages were remote and mainly at an operational level but over time have evolved into strong close relationships that focussed on how we could work together differently and help each other achieve better results for the community.

Agencies worked closely together from the outset to identify which agencies ought to be involved and to develop a strategic response to this identified threat. The Heads of Agencies were then quickly briefed on the available intelligence and rationale for the strategic cross agency response and they in turn briefed their respective Ministers.

This collaboration resulted in the development of a joint agency submission to the Government for additional funding to properly deal with those involved in this and similar arrangements and to scope the size and nature of this strategic threat into the future.

Securing Government support at a taskforce level

In February 2006, the Government announced the formal establishment of the Project Wickenby Taskforce to tackle this serious threat to the integrity of Australia's financial and regulatory system and agencies were allocated $308.8m over seven years.

The cross agency taskforce had an agreed objective to:

- make Australia unattractive to promoters of evasive and fraudulent international arrangements that threaten the integrity of Australian financial and regulatory systems (tax, corporate and criminal), and
- deter potential participants from such arrangements.

The strategic focus is to establish a strong deterrent for future promotion and participation while also encouraging those involved to promptly disclose their involvement and become compliant in their obligations.

Project Wickenby specific goals are to:

- reduce tax avoidance and evasion in the Australian tax system
- enhance the capabilities of Australian and international agencies to collectively detect, deter and deal with international tax avoidance and evasion. Individually, agencies and governments have only part of the picture; the shared view provides a more complete understanding
- reform administrative practice, policy and legislation, for example, by enacting section 3G of the Taxation Administration Act 1953 to allow information-sharing between agencies for Wickenby purposes, and
- improve community confidence in Australia's tax and corporate regulatory systems and assure the community that the government is tackling serious non-compliance with tax laws.

The model reflected in our approach, was to refrain from breaking down the project tasks into outputs and allocate the responsibility to each agency to deliver. Instead, an ongoing joint focus for all agencies was how we could work together to achieve the overall outcomes of the project for the benefit of the Australian community.

This proved powerful in a number of respects both internally within the Australian Public Service and externally in publicly demonstrating to key stakeholders that agencies are working well together to share intelligence, build capability and respond strategically to a significant integrity threat.

Setting up the formal infrastructure for the taskforce

Formally establishing project governance at an early stage is essential – however it is also important to recognise that this will need to evolve and change over the life of the project.
Key considerations to consider for project governance are:

- **Clear lead agency role** - the ATO had lead agency responsibility for the project that involved supplying taskforce management functions such as planning, reporting, dedicated cross agency relationship management and leadership support. It was important that the ATO help set the right open collaborative climate for how agencies came together to focus on the project outcomes. Partner agencies have acknowledged that this has been effectively achieved. A major reason is the strong history and culture of openness in the way the ATO engages and works with others, both internally and externally with strong emphasis on consultation, collaboration and co-design processes. There was significant early investment in building personal relationships between agencies and to understand each others objectives and challenges.

- **Partner agencies ongoing goodwill and active collaboration** - has been sustained despite the challenges inherent in managing the complexity of achieving the taskforce collective outcomes without unduly jeopardising the delivery of agency outcomes and exposing any reputation risks and the significant pressures applied through negative reporting in free media.

- **Endorsed Terms of Reference** - at an early stage of the taskforce, agencies worked together to develop formal Project Wickenby Terms of Reference to clarify and build shared understanding of

agency roles and responsibilities in achieving project outcomes. This process was useful in establishing how each agency saw their roles and responsibilities, clarified what was required to deliver the joint project outcomes related to these, as well as the occasional situation where it was necessary to flush out any areas of difference that needed to be resolved or at the very least carefully managed.

- **Governance forums**
  - The core element of the governance framework established from the beginning was a cross agency advisory committee that met face to face monthly with senior representatives from all agencies to jointly focus on what needed to be done, drive action out of session and monitor the set up and ongoing performance of taskforce activities. The secretariat support provided to this forum ensured that the key decisions were implemented and the right strategic conversations were held at the right time to oversee progress.
  - The heads of agencies meetings were unique to this project. They were held less frequently (quarterly) but provided an important accountability mechanism and valuable strategic direction throughout the life of the project.
  - Numerous other working groups are established as required, some ongoing and others for short periods on particular issues that report back to the monthly meeting.

- **Agreed working principles** - rigorous attention has been given to ensuring that all partner agencies are consulted on information products being developed for external use where they related to the project. While this added some complexity to the clearance processes that needed to be coordinated within the ATO, there has been a significant benefit to the quality of the product and the richer picture that has been able to be developed by incorporation of different perspectives. This has proved to be of significant value when we have had to deal with hot issues that have emerged in the media but have been able to develop integrated briefs by all agencies for all Ministers that ensure everyone has the whole picture.

- **Unified communication** - agreement to a unified voice when communicating on whole of project messages - there were also key ground rules established in our working relationships between partner agencies that recognised that while agencies have unique agency outcomes to deliver, if we failed to build and sustain a

'single Project Wickenby voice' with the external world we would not succeed in achieving our objectives for the benefit of the community.

A specific strategy was implemented to keep other agencies not directly involved in the project informed of progress and lessons learned from the Project Wickenby. For example we prepared reports that shared what we were doing and what we were progressively learning from our taskforce activities with other agencies through forums such as HOCOLEA (Heads of Commonwealth Law Enforcement Agencies).

- **Dedicated Relationship Management role** - a dedicated account manager was established for cross agency relationship management for partner agencies and also to respond to request for information regarding Project Wickenby activities from Ministers and other agencies.

Building infrastructure and capability quickly

This project required an exponential increase in the workforce across most of the agencies in both Taskforce Management/Leadership and operational capability, for example, recruitment exercises, cross agency planning, reporting and risk management.

The green fields operating environment of this project required innovation and flexibility in our approaches. For example, while the ATO has agency process specialists in a variety of disciplines who could provide initial guidance on processes and leadership for cross agency groups that were established, the reality proved to be that over time agencies shared their respective experience and expertise and there was a dynamic evolution and convergence of the multi agency contexts and different methodologies into unique agreed cross agency approaches that met the specific needs of Project Wickenby.

Four areas of joint capability providing important infrastructure initiative include:

- creating a virtual library of all the relevant training available across the partner agencies
- holding bilateral or multilateral workshops on key capability areas (for example, computer forensics)
- jointly developing new training programs where there are gaps in what is available, and

- exploring options for a jointly developed tertiary program to be provided by interested tertiary institutions.

As working relationships within working groups deepened there was a greater willingness to constructively challenge approaches and build sophisticated hybrid approaches. The investment in building collective understanding between partner agencies has helped to build a number of products that provide an integrated cross agency insight that also mask any unnecessary cross agency complexity.

We were frequently building new products and approaches creating an environment that supported integration of understanding; innovation in approaches that may include different ways of organising and focussing cross agency intelligence and risk capabilities; building new richer intelligence and risk management capabilities that are better positioned to anticipate, understand and treat any emerging threats.

Enhancing capabilities of our people

There has been a noticeable enhancement in our agency capabilities across the board through our collaboration in Project Wickenby such as:

- long term secondment/out posting to other agencies and short term task support – our people have increased their knowledge in investigations, preparing briefs of evidence, examination methodologies and analytical skills around a range of matters

- development and or provision by agencies of training in areas of specialisation – for example financial investigation based training by the Australian Federal Police, tax technical presentations by ATO to name only a few

- development and implementation of initiatives to increase the capability of investigative and regulatory agencies in identified tax haven countries. These have been coordinated with other Government programs such as the anti-money laundering assistance team initiatives

- regular requirement to collaborate in multi agency working groups or meetings has helped to:

    - o build collaboration skills by breaking down barriers

  - o increase knowledge and awareness of issues and challenges from the perspective of other agencies, and
  - o resulted in innovation and breakthrough approaches to long standing problems/blockers.

- greater recognition of the specialist skills of each agency that has on occasion challenged long held individual agency views of what is possible and how quickly an agency can respond, and

- interoperability enhancements have been slower to achieve but shifts are starting to be noticeable.

Influencing new approaches within agencies

The cross agency environment and collective focus on results served to highlight:

- internal connections that needed to be strengthened
- high impact results in influencing community attitudes that has prompted other internal areas to want to learn from our experience and apply this to other entrenched compliance challenges, and
- seeing a problem through multi agency perspectives results in creative solutions to better meet business needs. The breakthrough innovation and emerging effectiveness across a number of fronts has meant that long standing presumptions and paradigms of what is possible are under challenged and there is building enthusiasm to move to the next level. (e.g. interoperability of systems).

Building a whole of government strategy

This is the first time all agencies involved have worked collectively in a whole of government manner with clear project outcomes that need to be delivered.

The challenges in seven agencies, all covered by different legislative frameworks, procedures and processes, working successfully together cannot be underestimated.

It was recognised early on from the initial investigation work undertaken that the mischief uncovered crossed the boundaries of more than one government agency. To succeed in mitigating the associated threats was dependant on partner agencies working seamlessly together in an integrated manner to deal, detect and deter with financial arrangements

that included tax evasion/avoidance, money laundering and abuse of corporations' laws.

Reforming administrative practice, policy and legislation

The unique blend and complexity of agency relationships for each partner agency also takes time and effort to properly appreciate. These may be international (formal and informal), domestic at national and state jurisdiction levels and with private bodies in the community. There are sensitivities that need to be understood and constraints that need to be respected but when properly harnessed in a collaborative manner are very effective in providing a rich source of real time intelligence to assist the achievement of project outcomes.

The role of each agency is recognised and is subject to each agency's statutory powers and functions. Project Wickenby agencies have a substantial range of powers to assist in the investigation and prosecution of conduct associated with international tax mischief. Available methods include letters, notices, access visits, search warrants, examinations, action for breaches of taxation and corporation laws, and criminal prosecutions of serious and summary matters.

Two areas that have had to be tightly managed are around information sharing and separation of powers. Information Sharing and tax secrecy provisions did not provide for a partner agency to access ATO information, necessary for effective cross agency collaboration. The Project Wickenby agencies approached Government and put forward a request to have amendments to the income tax legislation which would enable the ATO to share information for the purposes of the multi agency taskforces.

Changes to Tax Administration Act 1953 (TAA) in relation to secrecy have now been implemented to support efficient and effective sharing of information from the ATO to Wickenby partner agencies.

Over time other legal constraints and impediments have continued to be highlighted for attention jointly by Project Wickenby partner agencies.

Harvesting intelligence from Work

As investigations activity has been significantly ramped up, attention has been given to developing emerging typologies that both aid future

analysis and detection of what type of arrangements we are uncovering. These typologies are also shared with others as they provide valuable intelligence to other agencies on what to look for and also in the case of AUSTRAC as to how and where the system reporting controls may need to be reinforced.

Further individual agencies have each undertaken reviews of investigations on their own initiative to identify what is working well and any lessons learned for the future.

Agencies have jointly also shared emerging intelligence and highlighted some areas of improvement. There is an ongoing need to further refine and distil strategic intelligence sufficiently across the full range of Project Wickenby activities to be able to inform senior management and Ministers of our assessment of the current situation and what response may be required into the future.

Providing catalyst for greater cooperative international approach

The strength and effectiveness of this united approach has also reached internationally with Project Wickenby now operating at not only across government but also across different jurisdictions.

Project Wickenby has a capability that assesses the regions of highest risk for the Australian revenue systems. This target selection also involves other tax jurisdictions and Government departments such as Department of Foreign Affairs and Trade, AusAid and the Attorney General's Department, all of whom have international links which assist the ATO to make country to country representations as required to identify areas of concern.

The ATO and other international revenue authorities are involved in one component project under Project Wickenby, where the primary mischief is the establishment of legal entities, especially foundations in Liechtenstein in order to hide beneficial ownership of assets and income and thus avoid taxation obligations. Capitalising on this opportunity a leveraged strategy has been developed that includes the ATO and Australian Federal Police working together with the revenue agencies of four other countries. Action has been taken simultaneously in four nations and the intelligence shared with action included:

- coordinating compliance action (on taxpayers and their associates) with domestic and international agencies simultaneously

- sharing data/intelligence between jurisdictions and international forums, and
- engaging with Liechtenstein and other risk regions to explore issues/reform options.

Feedback provided by an international revenue authority involved in this strategy was *‘from [our] perspective, this Project…has been a tremendous opportunity for collaboration and effective and timely communication with other treaty partners… As a whole, the project resulted in effective and timely international collaboration of intelligence and exchanges of information.’*

The only way to tackle this (international tax evasion and avoidance) is in a worldwide cooperative approach. Project Wickenby has been a catalyst for this at the operational level.

Improving community confidence

One of the key outcomes from Project Wickenby is to improve general community confidence in the integrity of our systems. To do so we need to influence sustained changes in behaviours of both participants and promoters of such arrangements.

We are seeking to promote greater transparency and accountability and to help the community understand what we are seeking to do, why we are doing it and also how effective we are in bringing people to account.

A critical element is to better understand attitudes and perceptions. To this end we have undertaken research to establish both a baseline against which to assess any shifts over the life of the project as well as identifying opportunities where we can influence attitudes in the future:

- general community research has been undertaken to better understand attitudes and perceptions of system and current action, and
- intermediaries research underway to better understand attitudes and how they influence the general community.

The tone of media commentary relating to Project Wickenby is also a useful indicator of impact. The media were extremely critical and

dismissive of agency efforts in the early phase of the project but more balanced and informed in recent times.

Some favourable indicators of improving compliance behaviours have been received in the form of market intelligence of increasing numbers of people approaching advisers wanting to come clean about past activities, others thinking twice about getting into arrangements involving tax havens. There have also been noticeable indictors in the form of 'ripple effect' from Project Wickenby activities with the amount of revenue collected along with increased numbers of voluntary disclosures associated with other compliance initiatives relating to tax havens.

As the project progresses agencies believe they will be in a far stronger position to provide accurate and timely advice on the environmental drivers and size of the risk that may then be used to drive future projects aimed at mitigating the current exposure to financial, revenue and regulatory systems by international tax promotion of financial arrangements.

9. CONCLUSION

The ATO's business model relies on risk management. We put our efforts into helping taxpayers operate at the base of our Compliance Model. We do this by identifying risks and developing appropriately tailored responses. What this means for taxpayers who try to do the right thing is that their compliance costs are minimised. Our focus on high risk areas and high risk taxpayers provides a more level playing field for all.[8]

Intelligence and risk management are separate but closely aligned capabilities – however good intelligence is fundamental to us being able to make informed decisions about what our risks are and how they need to be managed. We have learned that a robust intelligence capability needs to be built and developed over a period of years and built into the culture of an organisation.

Multi agency and multi jurisdictional approaches are not easy. They require more attention and mindful management than single agency

[8] *The OECD 2008 'Study in to the role of Tax Intermediaries' found that it is in the interests of the large majority of taxpayers to help tax authorities become better at risk management, better at recognising lower and higher risks, and better at not imposing extra compliance costs on lower risk taxpayers.*

approaches. However, current and future threats need to be effectively tackled, and require integrated approaches. This is increasingly the business of the future.

The benefits for agencies are more sophisticated and enhanced capabilities and more efficient and effective mitigation strategies, as well as realising the substantial benefit of improved support within the community in making the system fairer for all.

The investment in building good alliances and processes that better support working together on a multi agency and multi jurisdictional basis for one major project has led to longer lasting substantial improvements to agencies and the Australian community.

Case study

Topic 3.3

ORGANIZATION AND DEVELOPMENT OF TAX INTELLIGENCE ACTIONS AND ALLIANCES WITH OTHER GOVERNMENT AGENCIES

Alberto Real
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(Mexico)

CONTENTS: I. Executive Summary.- II. Background.- III. Tax evasion scheme.- IV. Strategic Alliances. - V. Taxpayers' detection. - VI. Risk assessment.- VII. Results obtained. - VIII. Conclusions

I. EXECUTIVE SUMMARY

The Tax Administration Service (SAT, as per its Spanish acronym) has developed strategic alliances with the Mexican Social Security Institute (IMSS, as per its Spanish acronym) and the National Workers' Housing Institute (INFONAVIT, as per the Spanish acronym), in order to detect, investigate and audit all the people involved in tax evasion in the outsourcing systems which are perpetrated by virtue of the legal status of corporations.

Such evasion is perpetrated by transferring the companies' workers to Cooperatives, with the purpose of avoiding dividend distribution, federal and local taxes as well as social security contributions

This joint effort is essentially aimed at protecting the country's workers who, by being integrated to these systems, lose access to health services, severance pay, retirement benefits, day care for their children and loans for appropriate housing.

The risk was initially detected in companies where the amount of income withholding and contributions to workers was drastically reduced when being transferred to such corporations.

In addition, the three agencies received claims both from affected workers and from members of the business sector, which gave rise to the study of tax evasion behavior and the identification of the people involved.

Joint audits are being coordinated by a strategic auditing group, which shall head and guide auditors from the three national agencies, in order to ensure the best results.

During the first year, it is estimated that the joint audit will reach 455 taxpayers.

II. BACKGROUND

The cooperative is one of the three types of corporations recognized in Mexico[1]. Since 1994, cooperatives have been ruled by special legislation: the General Cooperatives Law.

The purpose of this law is to regulate the organization and operation of cooperatives in the country.

The cooperative in Mexico is a type of social organization made up by individuals called cooperative partners, and is based on common interests and on the principles of solidarity, own effort and mutual benefit, with the purpose of meeting individual and collective needs, through the performance of economic activities of production, distribution and consumption of goods and services.

There are three types of cooperatives: Of consumers of goods and/or services, of producers of goods and/or services, of savings and loans.

Unlike other companies in which the company's operations yield profits, in cooperatives profits are produced, which are distributed among cooperative partners based upon the work contributed by each member during the year, taking into consideration quality, time, technical level and education.

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[1] *General Corporations Law.*

The cooperatives' capital is made up by the members' contributions and the profits generated by the operation, which are represented by nominative certificates, undivided and of the same value (comparable to a share in a corporation).

One of the provisions in this Law allows for the creation of several social funds, used by the cooperative to cope with contingencies, cover risks and diseases of the cooperative partners.

Types of social funds: Reserve, social security and cooperative education.

The most important fund is the social security fund, by means of which economic resources are allocated to reserves in order to cover risks, occupational diseases, medical expenses and funerals, day care for children, create pension funds and retirement salaries, seniority payments and other similar benefits for the cooperative partners.

This fund is the main element of the tax evasion scheme described in the following paragraph.

III. TAX EVASION SCHEME

The tax evasion scheme was detected in 2006 from the analysis of income tax withholdings, feedback received from the auditing areas, and claims filed by different members of the business sector.

Scheme detail (Graphic 1):

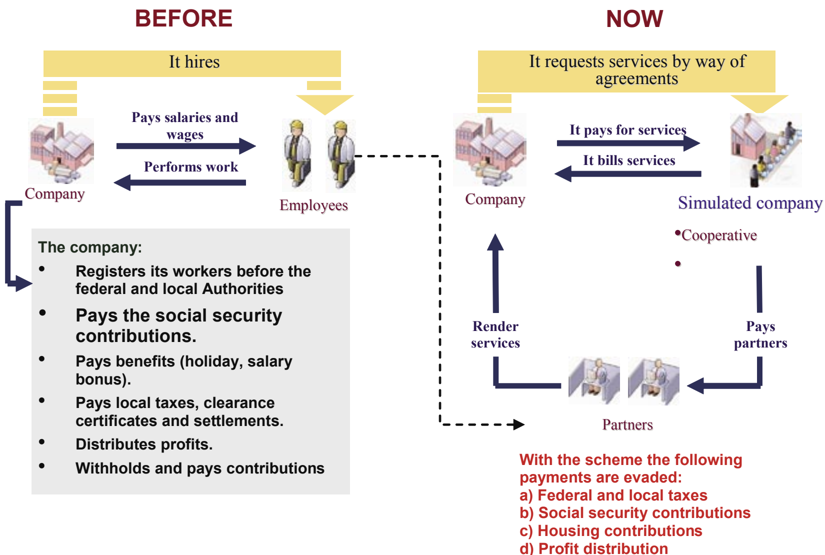
1. An advisory office sets up a cooperative, with neither infrastructure nor human resources (a simulated company).
2. The cooperative offers its clients to transfer their companies' payroll to the cooperative in order to avoid labor lawsuits, profit distribution, federal and local taxes, as well as social security contributions.
3. The company's employees are transferred to the cooperative and granted the condition of cooperative partners (paper formality).
4. The company requests staff services from the cooperative, and the latter provides them; the company pays by check / wire transfer and the cooperative issues an invoice with tax requirements.
5. Cooperative partners (formerly employees) keep on working in the company facilities, with the same working hours, regulations and roles (labor relation simulation).

6. The cooperative pays the cooperative partners from the social security fund, instead of paying by means of profits or advances on profits, which is the compensation definition set forth in the General Cooperatives Law[2] and which is subject to income tax as per the Income Tax Law[3].
7. The cooperative does not pay federal or local taxes, labor benefits, profit allocation, or social security contributions.

It is important to mention that the payments made from the social security fund that the cooperative gives to its partners are not deductible for the cooperative[4]; in addition, partners will have to add such payments to their income and make the calculation of the partial and total applicable tax[5].

Notwithstanding the foregoing, the economic savings brought about by this scheme to the companies is very attractive. This is the reason why, together with their tax and legal advisors, companies chose to undertake it, despite the risk of detection, auditing and sanctioning via the criminal and administrative law.

Graphic 1: Tax evasion scheme



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[2] *General Cooperatives Law, section 28.*
[3] *Income Tax Law, section 10, paragraph II.*
[4] *Income Tax Law, section 29.*
[5] *Income Tax Law, section 166.*

IV. STRATEGIC ALLIANCES

The evasion scheme directly affects Income Tax collection, since the companies involved stopped paying the withholdings made to their workers for wages and salaries; therefore, the Tax Administration Service (SAT) created an auditing program targeting cooperatives, companies receiving their services, businessmen related with them, groups of consultants and their own advisors.

Furthermore, it was observed that the scheme favored the failure to pay social security contributions, which gave rise to the creation of strategic alliances with two other federal agencies: the Mexican Social Security Institute (IMSS) and the National Workers' Housing Institute (INFONAVIT).

In Mexico, IMSS is the Authority responsible for ensuring the right to health, medical care, protection of livelihoods and social services for employee welfare[6].

As a tax authority, IMSS is in charge of collecting the contributions from workmen's compensation insurance, diseases and maternity leave, invalidity and life insurance, day care and social benefits; these contributions are upfronted partly by employers and partly by employees[7].

INFONAVIT is the institution in charge of managing the resources from the Workers' Housing Institute and of operating a financing system enabling workers to obtain cheap credit sufficient to purchase a home.[8]

INFONAVIT is considered a tax agency, empowered to collect the amount from the contributions allocated to the Workers' Housing Institute[9].

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[6] *Social Security Law.*

[7] *Internal Regulations of the Mexican Social Security Institute.*

[8] *Law of the National Workers' Housing Institute.*

[9] *Internal Regulations of the National Workers' Housing Institute Regarding Powers as an Autonomous Tax Agency.*

V. TAXPAYERS' DETECTION

In the first stage, SAT was in charge of performing the necessary tasks to identify within the population of taxpayers those involved in tax evasion.

Phase I Procedures:

The cases received with the results obtained from the research activities in open sources and the participation in several related forums increased; taxpayers' (cooperatives and clients) features related to tax evasion were examined and identified (Chart 1).

Chart 1: Features identified by SAT

Type	Feature
A	Cooperatives rendering staff / professional services.
B	Type A cooperatives not paying withholdings on income taxes for profits / advances on profits.
C	Type A cooperatives' clients who dramatically reduced the payment of tax withholdings on wages and salaries, as well as the number of employees.
D	Type B cooperatives' clients who dramatically reduced the payment of tax withholdings on wages and salaries, as well as the number of employees.
E	Cooperatives located in the same fiscal residences as those taxpayers detected in investigations / records.
F	Cooperatives having the same legal proxy as those taxpayers detected in investigations / records.

The taxpayers' population detected by SAT in Phase I (type A-F features), was sent both to IMSS and to INFONAVIT so that they analyzed the behavior shown by them when paying social security and housing contributions, respectively.

Phase II Procedures:

From the taxpayers' population sent by SAT, IMSS identified those who where employers and had very specific features in the amounts of social security contributions declared by them. (Chart 2).

Moreover, IMSS obtained data on employees who worked with them.

Chart 2: Features identified by IMSS

Type	Feature
G	Employers who reduced the payment of social security contributions.
H	Employers with employees who were registered with a certain salary and were subsequently transferred to a cooperative where they were registered with a minimum salary.
I	Employers who declared few employees, but provided cleaning, maintenance and surveillance services to large government agencies; these employers were at the same time clients of the cooperatives detected in Phase I.

The employers' population detected by IMSS was sent to SAT in order to consolidate a single database of tax evaders.

Phase III Procedures:

At the same time, INFONAVIT analyzed the population of taxpayers sent by SAT and selected those who were registered as employers; these had distinctive features when paying contributions for employee housing (Chart 3).

Similarly to IMSS, INFONAVIT obtained information on related employees.

Chart 3: Features identified by INFONAVIT

Type	Feature
J	Employers who reduced the payment of contributions for employee housing.
K	Employers with employees who were registered with a certain salary and were subsequently transferred to a cooperative where they were registered with a minimum salary.
L	Cooperatives which showed inconsistencies between the partners' quoted salary and the amortizations of mortgage loans granted to them before being transferred to the cooperative.

The taxpayers / employers' population detected by INFONAVIT was sent to SAT in order to consolidate tax evaders' data.

VI. RISK ASSESSMENT

The taxpayers selected in the three phases were classified into 25 categories, representing existing relationships between cooperatives and their clients.

Categories were created from the combination of specific features (A-L) and each was assigned a particular risk level according to SAT, IMSS and INFONAVIT's criteria (Graphic 2).

Graphic 2: Risk per Category

Corporative	It is a client	Decreased with holdings and employees (C and D)	Decreased SS contributions (G and J)	Transferred employees (H and K)	Government suppliers (I)
Partners with Inconsistencies (L)	High	High	High	Veru high	Very high
Investigation Representative (F)	High	High	High	Very high	Very high
Investigation Domicile (E)	High	High	High	Very hihg	Very high
Do not pay withholdings (B)	Medium	High	High	Very high	Very high
Service activities (A)	Low	Medium	Medium	High	High

Employer

Note: The graph does note include emoploers who are not customers of the cooperative

VII. RESULTS OBTAINED

The information obtained from the joint analysis process enabled the calculation of the estimated tax evasion by this scheme, which amounts to over 2 billion pesos, and the approximate number of affected employees: 232,000 nationwide.

In July 2008, joint audits were performed on 455 taxpayers, whose risk level was high or very high; this number includes cooperatives, cooperative partners and cooperative partners' clients.

Each agency is acting within the framework of its powers, and focusing on obtaining the necessary elements to define offenses and administrative sanctions.

SAT's auditing is aimed at determining non-compliance with tax obligations by cooperatives and cooperative partners.

On the other hand, IMSS and INFONAVIT are focusing on the cooperatives' clients in their capacity as employers, in order to establish sanctions in the labor field.

A joint training program is being delivered to the auditors of the three agencies located in the districts with higher incidences, where the

inspection strategy and the coordination they should have during audits are communicated to them.

Audits are coordinated by a strategic auditing group in charge of leading and advising auditors from the three agencies, with the purpose of ensuring the best results.

VIII. CONCLUSIONS

Every strategic alliance has advantages and disadvantages. In this particular experience, SAT obtained the following benefits:

- It exchanged databases with specific information from IMSS and INFONAVIT which improved existing information.
- It had more information to detect taxpayers involved in the tax evasion scheme.
- It made up a single register of taxpayers involved in this practice, which was useful for the three agencies.
- It profited from synergies to obtain efficient auditing actions.
- It profited from the staffing capacity of the other agencies in order to increase the number of taxpayers to be audited (more auditing presence).
- It will raise higher risk perception among those involved.

The only difficulty faced by SAT arose during the information exchange, since it was complicated to maintain correspondence among SAT's taxpayers and IMSS and INFONAVIT's employers; this situation was overcome by including and validating the code of the Federal Taxpayers' Registry in IMSS and INFONAVIT's databases.

Further alliances will be created with other federal agencies in order to fight different issues, leveraging the experience obtained in this program.

FINAL CONSIDERATIONS

FINAL CONSIDERATIONS

Mr. Nelson Hernández Lamarque
General Director of Revenue
General Directorate of Taxation
(Uruguay)

Good evening.

Mr. Nelson Hernández Lamarque

First of all, I would like to thank the SARS (South African Revenue Service) for giving me the opportunity to address all of you, and the Inter-American Center of Tax Administrations for entrusting me with the task of providing a summary of all the fruitful activities we have been carrying out over the last days and the preliminary conclusions of the meeting that dealt with the issue of "Topics Emerging from the Agenda of the Tax Administrations."

Non-fiscal function of Tax Administrations

The first topic of this conference concerned the **Non-Fiscal Functions of Tax Administrations.**

We should not disregard the Tax Administrations' function, which is the raising of funds intended to afford the State's expenses for primary activities. Such function could be subdivided into two objectives, namely: achieving an increase in taxpayers' voluntary compliance, and chasing tax fraud also as a way to promote voluntary compliance.
Despite being basic functions, they have allowed the Tax Administrations to develop certain skills that, in view of their proven efficiency, are frequently used for purposes that go beyond the raising of funds or the primary goals of Tax Administrations.

Hence, for example, when it comes to information analysis, database analysis, behavior analysis, Tax Administrations have gained some **"expertise"** that allows them to extend such skills to other fields of activity.

And in this sense, we could say that there may be no limits to such extension, for every day Tax Administrations will be required new functions or cooperation with at least issues related to the fulfillment of social aims or the State's ends or with anything associated with the affairs of Tax Administrations.

This is the reason that Tax Administrations often have an additional function mainly tied to the globalization process, as they facilitate commercial exchange, financial exchange between entities; that is, we speak of globalization in international terms.

But these skills gained by Tax Administrations also allow achieving a greater integration within each society, leading to greater citizen engagement in financing of the State's expenses and in the life within a society, that is, acting as citizens of a democratic society.

This is the reason that Tax Administrations' activities are many times connected with activities that could seem alien to them. So we speak of tax education; many administrations present here have departments specialized in tax education, which many times go beyond tax education itself to become actions targeted at achieving responsible citizens, at making citizens feel integrated to the society by reason of paying their taxes, and have a more active engagement in the social life, and taking on a spirit of solidarity that is inherent in the reality itself of our current society.

Therefore, Tax Administrations are required to perform other activities; but we should never forget what their main goal is.

That main goal remains being the raising of funds to finance State's expenses. Therefore, we should be careful in requiring new activities lest the administration's primary goal is neglected.

At this meeting, at least two different cases of extension of Tax Administrations' functions have been put forward.

Ecological taxes

One is connected with the so-called *ecological taxes*, or the effects that could be achieved through environmental protection-related tax measures.

On the one hand, we are talking specifically of tax measures concerning the implantation of taxes referred to environmentally-tied actions. What is the *raison d'être* of this taxation? From an ethical perspective, this could be that **if you contaminate, you should pay**; whoever is engaged in any activity that harms or hinders the conviviality environment, should pay for it. And on the other hand, maintaining the Environment, the environmental quality, implies that the State should incur expenses too, and so it is reasonable that those who contribute most be those who also contribute most to the depreciation of such State.

The experience in this sense has demonstrated that countries which have set forth tax burdens to protect the ecology or the so-called **ecological taxes or green taxes**, have done so not by increasing tax collection – that is, adding new taxes and new revenues- but rather by substituting other existing revenues. The cases we analyzed showed a replacement of direct taxation relating to income taxes, whether working or capital, by indirect taxation deriving from the affectation of natural resources.

Needless to say, this solution is not indistinctively applicable to all the countries present here. To be sure, the implantation of an ecological tax in Uruguay would not be substituting a direct tax but rather an indirect tax. So therefore, the grounds for implanting such tax would differ. Today, the cases analyzed have shown that the implantation of this indirect tax has meant a lower tax burden over certain individuals, allowing such indirect taxes to have greater acceptance on a social level.

This will surely not be the case in Latin American economies, at least to the extent that it would be substituting a value-added tax or would be, more than anything, redirecting a specific tax for the benefit of the environment.

Investment promotion

The other issue raised here in connection with the use of taxes for non-fiscal purposes is concerned with **investment promotion**.

And here, I think we should be very critical of the situation; that is, it has been said that the consideration and assessment of the use of taxes as a way to promote investments have undergone ups and downs.

Although some years ago the promotion of investments through taxes was acknowledged as valid and as one of the most adequate means for it, subsequently, in the light of the analysis of investment decision-making processes, which showed that the level of tax burdens is not among the primary elements to consider when making a decision, we have passed to a stage in which taxes are no longer used as a way to encourage investments.

More recently, as a result of the homogenization of the conditions for making investments, establishing tax incentives for investment has created a differential effect once again.

First off, we should take into account that when we use taxes as a way to encourage investments, what we are directly affecting in the first place is the fairness in distributing the tax burden. And we are not only affecting fairness but also waiving the use of taxes as a manner to redistribute revenues, which is one of the goals acknowledged to taxation as a supplement to the distribution of revenues resulting from the State's expenses.

Alternatively, when it comes to fiscal benefits or the results thereof, we should bear in mind that what is sought is not an increase in investments, but ultimately an increase in employment, or an increase in lifestyle levels, or improvement or innovation; and many times the results obtained from the promotion of investments are measured by an increase in investments, even though such investments may not be efficient or may not generate employment, or may fail to meet the requirements for which the benefit was conceded.

On the other hand, in granting a tax benefit to promote an investment we should assess what is being compromised, what is the value of what is being compromised.

We should be aware that there are quantifiable and non-quantifiable costs. I would say that a part of the non-quantifiable costs lies in what we previously stated regarding the assessment of the affectation of the system's fairness. But there are also quantifiable costs driving from a loss in revenues resulting from a tax incentive.

Even if there are differences as to how to quantify that loss, there are at least two or three procedures, namely:

- considering the cost *ex ante*, that is, the loss of revenues resulting from granting of a tax exemption or benefit;

- considering the cost *ex post*, that is, what would revenues have been if current investment behaviors had been maintained; or
- considering the suitability of incurring an expense and directly allocating the benefits instead of promoting investments through a specific tax deduction

All the above stated leads us to reflect upon the effects or the suitability of using taxes as a way to foster investments.

Tax control

The second issue raised at this conference was in connection with critical situations regarding **tax control**. Overall, the expositions were divided into two parts: those directly concerned with international taxation matters and those concerned with internal taxation.

As to international taxation, the issue of an aggressive tax planning was put forward, in which:

- tax benefits or differentials are improperly used to grant benefits to business persons in detriment of hosting states;
- the possibility of using tax havens or low-taxation systems is used to obtain benefits by transferring results from the places where benefits originate to the places where they are distributed;
- corporates or corporate intermediaries are used to displace results; or
- to displace activities, to separate effective activities from management activities; or
- everything related to the use of transfer prices that allow transferring results from countries with a normal taxation level to countries with a lower taxation level.

This is in relation to international taxation. In this regard, legal measures have been distinguished aimed at the protection of the resources by the different administrations, as well as administrative measures.

Other expositions concerned the establishment of legal measures in connection with the identification of low-taxation countries, transfer price systems or what I would call the most important of them: the predominance of the principle of substance over the form, which ultimately precedes the application of any protection or protection barrier system that each Tax Administration may impose in light of the displacement of results.

On the other hand, Administrations have also adopted administrative measures to avoid the displacement of results, deriving mainly from the follow-up of operations performed by large taxpayers. Some situations have been identified which provide for a registry and a digital follow-up of transactions, or a great effort in everything related to risk management, to select cases that prove or are suspicious of a deviation from the free competition rules regarding the treatment of international operations, to then extend the conclusions drawn from case analysis to the rest of the universe.

Overall, we should say that the Tax Administration need not work alone in these activities. I refer not only to activities on the level of international and local taxation control, but also that these activities should be performed by the society as a whole. This implies that lawmakers should be aware and provide the necessary instruments for adopting these protective measures. Obviously, the Administration should have the elements required to determine them, but it is also important that judges may act accordingly to adopt precautionary measures intended to defend the State's revenues, and also in tax evasion cases and property concealment, and thus be able to chase transgressors or defrauders, as per the case.

It is important, then, that a certain behavior exists on a state level, on the level of the society as a whole, intended to track down this type of activities, which are ultimately detrimental to the whole society.

Risk management

The third issue dealt with today was related to **risk**.
I believe that today everybody has somehow played down our conclusions or assertions, by saying that ultimately when we say that we have a problem, or an objective and have some actions to carry out, we always have to think that there is not absolute certainty regarding the achievement of our objectives, the performance of such objectives; and this is somehow related to the events that may occur which may alter the accomplishment of such objectives.

So it is important that there should be an awareness of the existence of this risk in every action, in every action carried out by the Administration; that we should be aware of the need to become aware of it – sorry for being redundant -; to be clear about the existence of this risk and to individualize it in order to minimize it.

Therefore, when analyzing every alternative, every option, objective, we must evaluate whether this objective is exposed to any events that turn it risky, and adopt the decisions of the Administration based on the existing risks and evaluating how they affect the achievement of the objectives.

What is important is that in order to minimize these risks, to more probably achieve each of the Administration's objectives, we need to gather up all the necessary information so as to be provided with all the judgment elements available, and thus minimize the risks.

We have seen several examples of application of this analysis; no matter how profound it is, we will never achieve a degree of absolute certainty. So we talk of an inherent risk and a residual risk. All our actions will be targeted at trying to have a lower residual risk. And I believe that this provides all of us administrators with a different vision of administration, a different vision of our everyday work.

So far, these are the somewhat quick conclusions of this Conference. Personally, I am most grateful for all the experience received, for the possibility of reflecting upon different approaches of our everyday work. And in particular, I would like to thank again the South African Revenue Service as hosting body, for the way it treated us and to distinguish once again the success of this Technical Conference of the Inter-American Center of Tax Administrations.

TECHNICAL PROGRAM

CIAT TECHNICAL CONFERENCE
Johannesburg, South Africa
September 29 to October 2, 2008

DAILY SCHEDULE OF ACTIVITIES

MAIN THEME: “TOPICS EMERGING FROM THE AGENDA OF THE TAX ADMINISTRATIONS”

Monday, September 29

Morning

09:00 - 09:30 Inaugural ceremony.

09:30 -10:00 Official photograph and Coffee Break.

Topic 1: The non-fiscal functions of taxation and their impact on the Tax Administration.

Moderator: Lyse Ricard, Assistant Commissioner, Canada Revenue Agency.

10:00 - 10:35 **Speaker:** Edward Kieswetter, Chief Operations Officer, SARS**,** South Africa (35´)

10:35 - 10:45 **Commentator:** Andrea Lemgruber, Technical Assistance Advisor, IMF (10´)

10:45 - 11:15 Debate (30´)

Topic 1.1: Environmental protection tax measures.

Moderator: Merlin Sergeant, Chairman, Board of Inland Revenue, Trinidad and Tobago

11:15 - 11-35 **Speaker:** Anthony Zom, Senior Policy Advisor, Ministry of Finance, The Netherlands (20´)

11:35 - 11:55 **Speaker:** Ralph Hoffman, Head of Tax Policy Section, Tax Department, Federal Ministry of Finance, Germany (20´)

11:55-12:25 Debate (30´)

Afternoon

Topic 1.2: Tax incentives and investment.

Moderator: Cecil Morden, Tax Policy Director, National Treasury, South Africa

14:30 - 14:50 **Speaker** Luiz Villela, Fiscal Economist, IDB (20´)

14:50 - 15:10 **Speaker** Juan Pablo Jiménez, Economic Affairs Officer, ECLAC (20´)

15:10 - 16:10 Debate (40´)

Tuesday, September 30

Topic 2: Critical tax control issues.

Moderator: Juan Hernández, Director General of Inland Revenues, Dominican Republic

09:00-09:35 **Speaker:** Jean-Louis Gautier, Deputy Director of Examination, General Directorate of Public Finance, France (35')

09:35-09:45 **Commentator:** Graham Whyte, Senior Advisor, Tax Co-operation and Accession, OECD (10')

09:45-10:15 Debate (30´)

Topic 2.1: Emerging risks in aggressive tax planning.

Moderator: Rudy Villeda, Tax Administration Superintendent, Guatemala

10:35-10:55 **Speaker:** Claudemir Rodrigues Malaquias, Tax Audit Coordinator, Brazil (20')

10:55-11:15 **Speaker:** Barry Shott, Deputy Commissioner (International) Internal Revenue Service, United States (20´)

11:15-11:45 Debate (30´)

	Topic 2.2:	**Regulation of holding companies and trusts.**
	Moderator:	Nathaniele Mabetwa, Group Executive Taxpayer Service, Revenue Service, South Africa
11:45 - 12:15	**Speaker:**	Pablo A. Porporatto, Advisor, General Deputy Directorate of Large Taxpayers Tax Operations, AFIP, Argentina (20')
12:15 - 12:35	**Speaker**	Sharon Gulliver, Manager, General Anti-Avoidance and Technical Support Section, Canada Revenue Agency (20')
12:35 - 13:05	Debate (30´)	
13:05 - 14:35	Lunch	
Afternoon		
	Moderator:	Michael Crichlow, Tax Commissioner, Office of the Tax Commissioner, Bermuda
	Topic:	**Mechanisms for e-commerce transparency**.
14:35 - 14:55	**Speaker:**	Ricardo Escobar, Director of the Internal Revenue Service, Chile (20')
14:55 - 15:15	**Speaker:**	David Boublil, Administrator, General Directorate of Taxation and Customs, European Commission (20')
15:15 -15:55	Debate (40´)	

Wednesday, October 1

Integration activity among the delegations of the member-countries, international agencies and special guests.

Thursday, October 2

Morning

Topic 3: Building, developing and applying risk management.

Moderator: Edward Kieswetter, Chief Operations Officer, Revenue Service, South Africa

09:00 - 09:35 **Speaker:** Vicente Peirats, Head of the Central International Relations Unit, State Agency of Tax Administration, Spain (35´)

09:35 - 09:45 **Commentator:** Claudino Pita, Executive Secretary, CIAT (10´)

09:45 - 10:15 Debate (30´)

Toíc 3.1: Relevant information for risk management.

Moderator: Marlene Ardaya, Acting Executive President, National Tax Service, Bolivia

10:30 - 10:50 **Speaker:** Joao Paulo Morais Canedo, Director of Tax Examination Services, General Tax Directorate, Portugal (20')

10:50 - 11:10 **Speaker:** Julio López, Deputy General Director, General Tax Directorate, Uruguay (20')

11:10 - 11:40 Debate (30´)

Topic 3.2: The use of technology: information systems and databases.

Moderator: Errol Hudson, Director General of The Tax Administration, Jamaica. (20')

11:40 - 12:00 **Speaker:** Oscar Franco, General Director of Taxes and Customs, Colombia (20')

12:00 – 12:20 **Speaker:** Enrico Martino, Director of International Relations, Finance Department, Ministry of Economic and Finance, Italy (20')

12:20 - 12:50 Debate (30´)

Afternoon

Topic 3.3: Organization and development of tax intelligence actions and alliances with other Government agencies.

Moderator: William Layne, Permanent Secretary of Finance, Barbados

14: 15 -14:35 **Speaker:** Alberto Real, General Administrator of Tax Examination, Tax Administration Service, Mexico (20')

14:35 - 14:55 **Speaker:** Raelene Vivian, Deputy Commissioner of Taxation, Australian Taxation Office Australia (20')

14:55 - 15:25 Debate (30´)

15:25 - 15:40 Evaluation of the event

15:40 - 16:10 **Final considerations:** Nelson Hernández, General Director, General Directorate of Taxation, Uruguay

16:10 - 16:30 Closing ceremony.

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Johannesburg, South Africa
September 29-October 02, 2008

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