TECHNICAL CONFERENCE

C·I·A·T
ROME · 2015

The Tax Administration's Examination Function

Rome, Italy, September 28th – October 1rst, 2015

About CIAT

CIAT is a public, nonprofit international organization established in 1967, with the mission of providing an integral service for the modernization, strengthening and technical development of the Tax Administrations of its member countries. Its membership currently consists of 38 member and associate member countries from four continents: 31 countries from the Americas, five from Europe, and one from Africa and one from Asia. India is an associate member country.

The Web site: www.ciat.org includes information of a technical and institutional nature, as well as on the various activities carried out such as international meetings, tax studies, publications, training, technical assistance and information technology.

Member Countries

Argentina
Aruba
Barbados
Bermuda
Bolivarian Republic of Venezuela
Bolivia
Brazil
Canada
Chile
Colombia
Costa Rica
Cuba
Curacao
Dominican Republic
Ecuador
El Salvador
France
Guatemala
Guyana
Haiti
Honduras
India
Italy
Jamaica
Kenya
Mexico
The Netherlands
Nicaragua
Panama
Paraguay
Peru
Portugal
Sint Maarten
Spain
Suriname
Trinidad & Tobago
Uruguay
United States of America

EXECUTIVE COUNCIL 2015- 2016

Diana Croes	Aruba
Jose David Cabello	Bolivarian Republic of Venezuela
Jorge Antonio Deher Rachid	Brazil
Aristóteles Nuñez	Mexico
Martin Rivas	Nicaragua
Marta González	Paraguay
Víctor Ramos	Perú
Santiago Menéndez Menéndez	Spain
John M. Dalrymple	United States of America

EXECUTIVE SECRETARIAT

Executive Secretary	Márcio F. Verdi
Planning and Institutional Development Director	Socorro Velázquez
Operations and Institutional Management Director	Francisco J. Beiner
Technical Assistance and Information and Communication Technology Director	Raúl Zambrano
Training and Human Talent Development Director	Alejandro Juárez
Tax Studies and Research Director	Miguel Pecho
International Cooperation and Taxation Director	Isaác Gonzalo Arias
Accounting and Finance Manager	Xiomara Tejada
Internal Administration and Human Resources Manager	Rita L. Solis
Information Technology Manager	Tomás Torres
International Cooperation Manager	Mónica Alonso

REPRESENTATIVES AND CORRESPONDENTS OF CIAT

Country	Representative	Correspondent
Argentina	Ricardo Echegaray	María Luisa Carbonell
Aruba	Luenne Gomez Pieters	Angeline Geerman-Griel
Barbados	Margaret Sivers	Margaret Sivers
Bermuda	Lucia M. Peniston	Mary Inocencio
Bolivia	Erik Ariñez Bazán	Juana Patricia Jiménez
Brazil	Jorge Rachid	Flávio Araújo
Canada	Michael Snaauw	Rose Jarawan
Chile	Fernando Barraza	Bernardita Moraga
Colombia	Santiago Rojas Arroyo	Patricia Parada
Costa Rica	Carlos Vargas Durán	Maribel Zúñiga C.
Cuba	Yolanda Álvarez de la Torre	Alberto Fernández R.
Curazao	Jamila Isenia	Yut-Ha Natalie Sint Hil
Dominican Republic	Guarocuya Félix	Nieves Vargas Collado
Ecuador	Ximena V. Amoroso Iñiguez	Juan M. Avilés Murillo
El Salvador	Alfredo Díaz Barrera	Ramón Pérez Gómez
France	Bruno Parent	Josiane Lanteri
Guatemala	Francisco Rivera Escobar	Hugo Edgardo Roldán V.
Guyana	Khurshid Sattaur	Janet Abbensetts
Haiti	Miradin Morlan	

Honduras	Miriam Guzman	Gabriel Perdomo
India	Rajat Bansal	Deepak Garg
Italy	Saverio Capolupo	Stefano Gesuelli
Jamaica	Ainley Powell	Meris Haughton
Kenya	John Karimi Njiraini	Pancrasius Nyaga
Mexico	Aristoteles Nuñez	Adrián Guarneros
Nicaragua	Martin Rivas Ruíz	José Francisco Reyes
Panamá	Publio Ricardo Cortés	Marion Lorenzetti
Paraguay	Marta González Ayala	Alba Servin
Peru	Víctor Ramos	Rosalia Muñoz
Portugal	Helena Maria Borges	Miguel Silva Pinto
Sint Maarten	María Bass	
Spain	Santiago Menéndez Menéndez	Ignacio Del Rio Angulo
Surinam	Cornelis A. van Dijk	Priscilla Lachman
The Netherlands	Peter Veld	Jaco Tempel
Trinidad & Tobago	Allison Raphael	Trevor Lalai
United States	John M. Dalrymple	Raúl Pertierra
Uruguay	Joaquín Serra	Margarita Faral
Venezuela (Bolivarian Rep.)	José David Cabello Rondón	Hatzen Carolina Mendoza

PERMANENT TECHNICAL ASSISTANCE MISSIONS

France

Head of Mission: Isabelle Gaetan

Spain

Head of Mission: Juan Francisco Redondo

Italy

Head of Mission: Stefano Gesuelli

GIZ-German Cooperation

Head of Mission: Joerg Wisner

CIAT 2015 Technical Conference Theme:

"The Examination Function of the tax Administration"

At the CIAT 2015 Technical Conference we will discuss "The Examination Function of the Tax Administration." This function, sometimes referred to as "Control", is one of the vital elements of all tax administrations. Through compliance verification in different forms, it is the unit that attempts to ensure that tax-liable entities are properly complying with the tax laws.

The subject will be addressed from several aspects: current trends, resource needs, and innovative approaches to enhance the examination process.

Topic 1: Current situation, trends and challenges in the use of examination techniques.

Change is constant in the fiscal world and so is the environment in which tax officials execute their missions. There are many factors to consider and these are interwoven with global trade and the increased challenges posed by multinational enterprises. New technology offers previously unavailable tools for the audit process but at the same time grants major opportunities for the tax cheat. In order to discover advanced methods to successfully address tax avoidance and evasion, and at the same time join hands with the universe of tax administrations facing similar tasks, international organizations have collaborated with these tax administrations in an effort to enhance compliance with their tax laws. Topic 1 will address tax examination current and novel approaches in tax examination/audit in order to ensure tax

Subtopic 1.1: Development of Examination Plan; focusing on issues to be reviewed and information sources and intelligence.

Key to a successful tax administration examination program is a well-executed annual plan. Among the goals to be achieved, tax administrations include specific compliance objectives. These include priority issues that will be addressed by the Examination Department; a balanced, equitable approach to ensure that a proper number of audits are completed in taxpaying sectors; mass third party reporting verification is timely completed; and, resources are adequately allotted to each area. Under Sub-topic 1.1 we will explore the key factors of a successful examination plan and the elements that need to be considered.

Subtopic 1.2: The powers of the Tax Department vis-a-vis the taxpayer rights and guarantees during the examination process.

For the average citizen, the tax department may be the one government entity they most frequently deal with. And possibly, the one that may cause the most concern to the taxpayer due to that agency's authority and power. But with great powers comes great responsibilities and accountability. In most societies the taxpayer is the constituent whom through the exercise of their vote, directly or indirectly, determine their rights. Taxpayers have the right to know what they need to do to comply with the tax laws. They are entitled to clear explanations of the laws and tax procedures in all tax forms, instructions, publications, notices, and correspondence. They have the right to be informed on decisions about their tax accounts and to receive clear explanations of the outcomes and their recourse if not in agreement with the result of an audit. Sub-topic 1.2 will explore the powers of the state to audit a taxpayer and the rights granted the taxpayer.

Subtopic 1.3. The use of presumptive methods in examination.

The use of presumptive methods to assess an entity's or individual's tax liability has been around for some time. It has been employed in programs where the taxpayer is completely cooperative and in agreement with the process; and, in expeditious assessments where potential collection of the tax to be assessed is in jeopardy. The Speakers on this Subtopic will address current creative uses of this indirect method to improve compliance and enhance the efficiency of resources.

Subtopic 1.4: The control of withholding agents.

Through the provision of statutes withholding agents operate on the basis of trust to temporarily hold funds belonging to the state provided by a third-party, a taxpayer. The sources are various, income tax, social security, VAT, sales taxes, etc. Often those collected funds are not partially or completely transferred over to the tax administration. While some tax administrations have developed novel approaches for taxpayers to verify their withholdings and deposits, many become unaware of inappropriate use of their contributions – in particular social security contributions.

This session will address and present alternatives to ensuring that the proper amounts of taxes are withheld and properly deposited in the governments coffers. The control models would be applicable to all types of taxes.

Topic 2: Non-traditional sectors to be examined: Challenges and experiences.

It may be an overused pun, but truly, everything changed with the advent of the Internet and the digital economy. We have experienced this in our lifetimes and on a day-to-day basis; from paid in cash to digital transfers to our bank accounts; purchases with currency we never see; and, payments of monthly bills online.

In the meantime new forms of cyber-currencies were created. Business operations were set up that challenged the definition of a “permanent establishment.” Brick-and-mortar commercial operations gave way to a new form of online business operation. People are able to gamble and earn a living from the comfort of their homes. And in the end, new forms of wealth enrichment opportunities have been created that are difficult to detect and far more difficult to

The tax administration human resources have also been challenged. Greater skills and knowledge are required to detect noncompliance and address it through controls and audits.

The Speakers for these sessions will address these issues from the perspective that these new challenges present.

Subtopic 2.1: Tax control of the digital economy .

The session will address challenges that tax administrations are facing to control entities whose books and records are primarily on automated systems. Also, how do we control entities whose business model and market revolve around the Internet? Issues may also be related to offshore transactions via electronic financial transfers; services provided for an entity by vendors in one jurisdiction and whose finished product may be documents that can be sent via email (programmers, architects, writers, etc.) to another jurisdiction. For tax purposes, where are the services rendered? Where are the payments made and to whom?

Subtopic 2.2: The taxation of high net worth and high-level income taxpayers (individuals).

Very high net worth individuals have been christened with the dubious title of “world citizens.” These may be the so-called “One Percent” we often hear about through the media that control 40 percent of a nation's wealth. Wealth of these proportions begets the need for highly creative methods to reduce as much as possible the tax bill to the state.

To some degree or another, most tax administrations face this challenge, taxing the super rich in their jurisdictions, in a fashion that is in keeping with the equitable treatment afforded all taxpayers.

Subtopic 2.3: Human Resources (HR) and the examination programs.

The task of preparing auditors to execute their mission gains in complexity as we add on new business types. The expansion of the digital economy certainly has helped add to that complexity.

Tax auditors enter the tax administration via several avenues; some enter with accounting degrees then receive additional training through the tax administration. Specialized training may be in-house or contracted with a university. Some of the specialized topics may be courses on computer audit specialist, financial products and instruments, valuation of art and collectibles, forensic accounting, and others. The models vary.

Also, many have continuing education programs to ensure that the auditors' skills are kept up to date on emerging issues and technologies.

The Speakers in this session will discuss their training programs in support of their examination programs.

Topic 3: Taxation of multinational enterprises including issues covered by the G-20/OECD BEPS initiative.

The taxation of multinational enterprises (MNE) entails a significant number of factors to be addressed and considered. These range from a subsidiary's relationship with its parent entity, permanent establishment issues, rules and regulations pertaining to controlled foreign corporations, transfer pricing, to tax treaty issues to name just a few. By far they are the most complex entities to control and these complexities increase depending on the nature of their business-line. Few tax administrations are completely equipped to address all the factors that the control of MNEs present. Adequately skilled human resources are one of the significant

During the last couple of years the G-20/OECD BEPS initiative has been created and rolled out with the hopes of addressing the tax compliance issues related to MNEs and other entities.

The Topic 3 session will focus on the efforts of tax administrations to properly control MNEs and, where applicable, discuss how elements of the BEPS initiative have been used favorably.

Subtopic 3.1: Tax Examination and other procedures (penal and civil, national and international).

The process and/or outcome of an examination may require access to many avenues for resolution. These may be in the form of a tax treaty or tribunal. Within these options there are a number of other international agreements that do not conform to the traditional standards of a bilateral double taxation treaty. One example is the Mutual Legal Assistance Treaty (MLAT).

The jurisdiction's legal systems also offer alternatives. These may be criminal or civil.

The Speakers will comment on the avenues of resolution they seek by employing the courts and international agreements in order to resolve examination issues.

Subtopic 3.2: When international tax avoidance becomes tax fraud.

The simple definition of tax fraud is: Tax fraud is the willful and intentional act of lying on a tax declaration for the purpose of lowering one's tax liability - or simply not filing at all. However, to prove tax fraud in a court of law – for civil or criminal purposes – that's another matter. The simple factors to be proven are that it was "willful" and "intentional." However, there are other issues to address, for example, economic substance.

For many jurisdictions, “economic substance” is a doctrine in the tax law under which a transaction must have an economic purpose aside from the reduction of tax liability in order to be considered valid. This doctrine is used to determine whether tax shelters, or strategies used to reduce tax liability, are considered "abusive" or bordering on tax fraud.

During this session, Speakers will address example cases and inform on what are the key factors that differentiate avoidance from fraud.

Subtopic 3.3: Tax control of cross-border operations and transactions.

Like the digital economy, globalization presented tax and customs officials new opportunities and challenges. Of major concern was the control of contraband which left one jurisdiction free of VAT, and other taxes, only to reenter the same jurisdiction and go on the market. In many jurisdictions tax administrations created innovative approaches to control the contraband and tax evasion with package-tax stamps and radio-frequency Identification (RFID) chips. This is just one aspect of tax control of cross-border operations and transactions. There are many more. And depending on the volume and type of trade, different controls are applied.

The session will allow us to learn of other novel approaches being utilized by the tax and customs administrations in their effort to control cross-border operations.

Round Table Discussion

Topic: The future of the control function of the tax administration.

The only thing that we can predict about the future with a high degree of certainty is, that there will be change.

And having this in mind, how do tax administrations prepare for that change? And what kind of change can we expect? How will it affect us?

The type of change can be of several forms: global economy; technology; political; natural disasters, etc. For some we can certainly prepare for and benefit from or mitigate results. And that is the question here: what can we expect, and how will it impact the examination/control function?

The last decade has seen significant efforts by tax administrations around the world to unite under one voice and find answers to address the ever-growing difficult task to control multinational enterprises and tax evasion. The focus has not been strictly on tax administration; change has also been required on fiscal policy and tax laws. Progress has been made. For sure we can expect comeback from these entities. And there lies the issue,

DAILY SCHEDULE OF ACTIVITIES

Monday, September 28

Hour			TOPIC	
From	To	Time		
9:00	**9:45**	**0:45**	**Inaugural Ceremony**	
			Statement by the CIAT Executive Secretary, Márcio F. Verdi	
			Statement by the Executive Council President	
			Welcome Stement by the Commander-in-Chief of the Guardia di Finanza	
			Statement by H.E. the Minister of Economy and Finance of Italy	
9:45	10:15	0:30	Official photograph, coffee and integration	
10:15	**11:00**	**0:45**	**Inaugural Conference:**	
11:00	**12:15**	**1:15**	**Topic 1: Current situation, trends and challenges in the use of examination techniques**	
11:00	11:05	0:05	Moderator	Fabrizia Lapecorella, Head of the Finance Department of the Ministry of Economy and Finance, Italy
11:05	11:25	0:20	Speakers	Santiago Menéndez Menéndez, General Director, State Agency of Tax Administration, Spain
11:25	11:45	0:20	Speakers	Theodore Setzer, Acting Assistant Deputy Commissioner (International), Internal Revenue Service, USA
11:45	12:00	0:15	Commentator	João Canedo, Large Taxpayer Unit Director, Tax and Customs Authority, Portugal
12:00	12:15	0:15	Debate	
12:15	13:35	1:20	Lunch	
13:35	**14:35**	**1:00**	**Subtopic 1.1: Development of Examination Plan; focusing on issues to be reviewed and information sources and intelligence**	
13:35	13:40	0:05	Moderator	Alice Neves, Administrator, General Tax Administration, Angola
13:40	14:00	0:20	Speakers	Fabrizio Toscano, General B., Guardia di Finanza, Italy
14:00	14:20	0:20	Speakers	Jorge Rachid, Secretary, Federal Revenues of Brazil
14:20	14:35	0:15	Debate	
14:35	**15:35**	**1:00**	**Subtopic 1.2: The powers of the Tax Department vis - a - vis the taxpayer rights and guarantees during the examination process**	
14:35	14:40	0:05	Moderator	Miguel Silva Pinto, Deputy General Director, Tax and Customs Authority, Portugal
14:40	15:00	0:20	Speakers	Jarkko Orjala, Auditing Process Director, Finnish Tax Administration, Finland
15:00	15:20	0:20	Speakers	Rossella Orlandi, Revenue Agency Director, Italy
15:20	15:35	0:15	Debate	
15:35	15:55	0:20	Coffee and integration	

15:55	**16:35**	**0:40**	**Subtopic 1.3:The use of presumptive methods in examination**	
15:55	16:00	0:05	Moderator	Socorro Velázquez, Planning and Institutional Development Director, CIAT
16:00	16:20	0:20	Speakers	Alice Owuor, Commissioner of Domestic Taxes, Kenya Revenue Authority.
16:20	16:35	0:15	Debate	
16:35	**17:35**	**1:00**	**Subtopic 1.4: The control of withholding agents**	
16:35	16:40	0:05	Moderator	Carlos Vargas Duran, General Director of Taxation, General Directorate of Taxation, Costa Rica.
16:40	17:00	0:20	**The employer´s compliance with payroll requirements - the Canadian approach and practices**	
			Speakers:	Michael Snaauw, Assistant Commissioner, Canada Revenue Agency.
17:00	17:20	0:20	Speakers:	José Antonio Bianchi, Deputy General Director of Collection, Federal Administration of Public Revenues, Argentina.
17:20	17:35	0:15	Debate	

Tuesday, September 29

Hour			TOPIC	
From	To	Time		
9:00	**10:15**	**1:15**	**Topic 2: Non - traditional sectors to be examined: Challenges and experiences**	
9:00	9:05	0:05	Moderator:	Marta Beatriz González Ayala, Deputy Minister of Taxation, State Undersecretariat of Taxation, Paraguay.
9:05	9:25	0:20	Speakers:	Stefano Screpanti, Head of the Operations Department of the Guardia di Finanza General Command, Italy
9:25	9:45	0:20	Speakers:	Victor Villalón, Deputy Director of Examination, Internal Revenue Service, Chile
9:45	10:00	0:15	Commentator:	Francisco Javier Beiner, Operations and Institutional Management Director, CIAT
10:00	10:15	0:15	Debate	
10:15	10:35	0:20	Coffee and integration	
10:35	**11:35**	**1:00**	**Subtopic 2.1:Tax Control of the digital economy**	
10:35	10:40	0:05	Moderator:	Errol Ramsubeik, Commissioner, Legal and Administration, Board of Inland Revenue, Trinidad & Tobago
10:40	11:00	0:20	Speakers:	Raúl Zambrano, Technical Assistance and Information Technology and Communication Director, CIAT
11:00	11:20	0:20	Speakers:	Jorge Rachid, Secretary, Federal Revenues of Brazil
11:20	11:35	0:15	Debate	
11:35	**12:55**	**1:20**	**Subtopic 2.2: The taxation of high net worth and high level income taxpayers (Individuals)**	
11:35	11:40	0:05	Moderator:	Atulesh Jindal, Member, Central Board of Direct Taxes, Ministry of Finance, India.
11:40	12:00	0:20	Speakers:	Martin Ramos, National Tax Superintendent, National Superintendency of Customs and Tax Administration, Peru
12:00	12:20	0:20	Speakers:	Ximena Amoroso Iñiquez, General Director, Internal Revenue Service, Ecuador,
12:20	12:40	0:20	Speakers:	Martine Meunier, High Level Consultant at the Regional Directorate of Paris, Directorate General of Public Finances, France
12:40	12:55	0:15	Debate	
12:55	14:25	1:30	Lunch	

Wednesday, September 30

Hour			TOPIC	
From	**To**	**Time**		
9:00	**10:20**	**1:20**	**Topic 3: Taxation of multinational enterprises including issues covered by the G-20/OECD BEPS Initiative**	
9:00	9:05	0:05	Moderator:	Jaco Tempel, Strategic Advisor to the Commissioner, Tax and Customs Administration, Netherlands.
9:05	9:25	0:20	Speakers:	Daniel Álvarez, Public Sector Senior Specialist, World Bank
9:25	9:45	0:20	Speakers:	Andrea Lemgruber, Deputy Division Chief, International Monetary Fund
9:45	10:05	0:20	Commentator:	Raffaele Russo, Head of the BEPS Project, OECD
10:05	10:20	0:15	Debate:	
10:20	10:50	0:30	Coffee and integration	
10:50	**12:00**	**1:10**	**Subtopic 3.1: Tax Examination and other procedures (penal and civil, national and international)**	
10:50	10:55	0:05	Moderator:	Joaquín Serra, Director General of Revenue, Uruguay
10:55	11:20	0:25	Speakers:	Ignacio Suárez Fernández. Technician in charge of the Struggle against corruption, COMJIB
11:20	11:45	0:25	Speaker:	Stefano Gesuelli, Head of the Permanent Italian Mission at CIAT, Guardia Di Finanza, Italy
11:45	12:00	0:15	Debate:	
12:00	13:30	1:30	Lunch	
13:30	**14:30**	**1:00**	**Subtopic 3.2.: When international tax avoidance becomes tax fraud**	
13:30	13:35	0:05	Moderator:	Donnette Sommerville Mills, General Manager, Large Taxpayer Office, Tax Administration, Jamaica
13:35	13:55	0:20	Speakers:	Guarocuya Felix, Director General of Internal Taxes, Dominican Republic.
13:55	14:15	0:20	Speakers:	Luis María Sánchez , Director of Examination Department, State Agency of Tax Administration, Spain
14:15	14:30	0:15	Debate:	
14:30	**15:50**	**1:20**	**Subtopic 3.3: Tax control of cross-border operations and transactions**	
14:30	14:35	0:05	Moderator	Egil Martinsen, International Director, Directorate of Taxes, Norway.
14:35	14:55	0:20	Speakers:	Ricardo Ibarra, Central Management Planning and Evaluation Administrator, Tax Administration Service, Mexico.
14:55	15:15	0:20	Speakers:	Chang-ryung Han, Technical Officer, World Customs Organization
15:15	15:35	0:20	Speakers:	Nicola Sudan, Associate Director, Reconnaissance International Ltdd, RI-Corporation
15:35	15:50	0:15	Debate:	
15:50	16:20	0:30	Coffee and integration	

Thursday, October 1st.

Hour			ROUND TABLE	
From	**To**	**Time**		
09:00	**11:00**	**02:00**	**Topic: thefuture of the control function of the tax administration**	
			Moderator:	Márcio Ferreira Verdi, Executive Secretary, CIAT
			Participants:	World Bank, Chile, Italy, Kenya, Mexico, Peru
11:00	11:30	0:30	Coffee and integration	
CLOSING CEREMONY				
11:30	**12:30**	**01:00**	**Closing**	
11:30	12:00	00:30	Rapporteur:	Miguel Silva Pinto, Deputy General Director, Tax and Customs Authority, Portugal
12:00	12:15	00:15	Invitation to 2016 Mexico General Assembly	
12:15	12:30	00:15	Closing Ceremony	
12:30	14:00	01:30	Lunch	

Topic 1

ISSUE-BASED AUDITS AND THE AGILE MODEL
SUMMARY

Theodore Setzer
Acting Assistant Deputy Commissioner (International)
Internal Revenue Service
(USA)

Contents: I. Introduction. II. The development of an international tax administration. III. LB&I's challenges in today's operating environment. IV. The path forward: transition to a future state. V. Future state: risk based examinations, Practice Areas, and a Holistic Approach to Tax Administration. IV. Conclusion

A government's return on investment in their own tax administration cannot be underestimated. Yet, tax administrations across the world are being asked to do more with less. For every dollar invested in taxpayer services and enforcement programs the IRS can have between a 6-to-1 and 20-to-1 rate of return;[1] however, the IRS has experienced five years of declining budgets.[2] Shrinking resources and an increasingly complex, dynamic global environment have caused the IRS and other tax administrators to question whether previous techniques will continue to be successful in the current and evolving operating environment. How tax administrators approach examinations and engage taxpayers will impact how they navigate an increasingly complex global business landscape.

This paper discusses how the Large Business & International Division (LB&I) of the Internal Revenue Service (IRS) plans to manage changes in today's business and regulatory environment by identifying the highest tax compliance risks and applying examination techniques focused on those areas. The taxpayer population of LB&I is business entities with assets of $10 million or more, as well as high-wealth individuals and individuals with international tax aspects. LB&I received approximately 300,000

[1] Koskinen, *Statement of IRS Commissioner John Koskinen on the Fiscal Year 2016 Budget* ("Koskinen"), Feb. 2, 2015, available at http://www.irs.gov/uac/Newsroom/Statement-of-IRS-Commissioner-John-Koskinen-on-the-Fiscal-Year-2016-Budget
[2] Id.

large business returns for the 2013 processing year.[3] That same year, the IRS received over 870,000 income tax returns from individual international taxpayers.[4]

The IRS is enhancing its approach to auditing large business entities and international taxpayers by moving from a taxpayer-based approach to an issue-based approach.[5] Risk assessment is a part of the issue-based approach that helps LB&I to be more strategic and selective in identifying the taxpayers and the issues to be examined. A review of existing programs identified effective and efficient processes for tax administration and led to the transition to an issue-based approach. Achieving effective outcomes from this risk assessment approach requires LB&I to use an operational model that continually identifies new risks and improves compliance in specified areas. Those improvements will be informed by feedback mechanisms that facilitate adjustments to how LB&I responds to taxpayer behaviors.

I. INTRODUCTION

Tax administrations across the globe are being challenged by the rapid globalization of markets, business models, and financial systems.[6] Governments are also working together to ensure that taxpayers comply with the tax obligations of their home jurisdictions.[7] This is evidenced by initiatives such as the Organization for Economic Co-operation and Development (OECD)/G20 Base Erosion Profit Shifting (BEPS) Project. To adapt and effectively face these challenges, tax administrators must reflect on their processes and procedures and consider how to respond to new demands and taxpayer behaviors.

Meanwhile, tax administrators are facing diminishing human resources and limited funding, which restricts their ability to hire and train employees and operate functionally and efficiently. These issues challenge a tax administrator's ability to enforce the increasingly-complex tax laws in a global environment that is further complicated by an increasingly-sophisticated taxpayer population.

---

[3] Large Corporations are those corporations that have balance sheet returns of $10 million or over. For more information on the taxpayer population serviced by the IRS, see *IRS Data Book 2014* ("IRS Data Book 2014"), available at http://www.irs.gov/pub/irs-soi/14databk.pdf. See also http://www.irs.gov/uac/SOI-Tax-Stats-International-Business-Tax-Statistics

[4] This number totals individuals submitting Form 1040-C (income tax return for departing aliens), 1040-NR (nonresident alien income tax return), 1040NR-EZ (income tax return for certain nonresident aliens with no dependents), 1040-PR (self-employment income tax return for Puerto Rico residents), 1040-SS (self-employment income tax return for U.S. Virgin Islands, Guam, American Samoa, and Northern Mariana Island residents). IRS Data Book 2014 at 4.

[5] Internal Revenue Service Advisory Council 2014 Public Report ("IRSAC 2014"), p. 47, available at http://www.irs.gov/PUP/taxpros/2014-IRSAC-Full-Report.pdf

[6] Koskinen, fn. 1.

[7] Id.

Although it faces significant challenges, the IRS remains committed to serving taxpayers and finding new ways to assist them.[8] For example, in order to address how the IRS's restricted budget is impacting its response to taxpayer requests it has looked for alternative methods for communicating with taxpayers.[9] The IRS now has more tax and filing information available online through its website, IRS.gov. It also has developed new online services such as, "Where's My Refund?" to help taxpayers keep track of their personalized refund date.[10] These efforts assist the agency in ensuring its limited resources are leveraged effectively.

Within LB&I, some of these efforts have been internally focused. LB&I launched a rigorous peer review of cases to understand and assess the examination process. At the same time LB&I conducted a holistic review of programs to identify broader areas for improvement. Both reviews highlighted the need for the IRS to mobilize its greatest resource, its workforce, to effectively identify new and growing areas of risk. An agile operational model ensures that LB&I can respond to changes in taxpayer behavior and modify risk assessment as needed. Achieving effective outcomes in a changing environment is dependent on LB&I's workforce being deployed against its greatest risk areas while still focusing on increased taxpayer compliance. Thus, the result of these reviews was a series of discrete projects aimed at improving the audit process.

Today, the key objectives for LB&I include identifying and managing the highest areas of tax compliance risks, mobilizing personnel around those risks, and measuring alternative mechanisms to ensure achievement of results. Each of these elements is critical for LB&I to deliberately apply its agency resources to address specific risk areas. They will also assist LB&I in remaining reflective and agile in reallocating resources where appropriate.

II. THE DEVELOPMENT OF AN INTERNATIONAL TAX ADMINISTRATION

In 2000, the IRS stood up the Large and Mid-Size Business Division ("LMSB"). LMSB served corporations and partnerships with assets greater than $5 million. In 2000, approximately 248,000 corporations and partnerships filed returns with assets in that range and paid more than $700 billion in federal taxes.[11] These returns presented a wide range of complex issues.

The LB&I annual Compliance Plan communicates the service and compliance objectives of LB&I for a single fiscal year. The Compliance Plan matches available resources with operational priorities to set projected return closures for critically important programs.[12] Individual agents are responsible for determining the specific compliance risks of their caseload. This return closure-based compliance plan

[8] IRS Data Book 2014, fn. 3, p. iii.
[9] Id.
[10] http://www.irs.gov/Refunds
[11] Internal Revenue Service, "Announcement and Report Concerning Pre-Filing Agreements", ("Announcements") p. 1, available at http://www.irs.gov/pub/irs-drop/a-01-38.pdf
[12] IRM 4.46.2.1 (03-01-2006), ("IRM 4.46.2.1").

emphasizes meeting annual markers and focuses on the percentage of taxpayers that are covered.

Since the stand-up of LMSB, time issue management has remained a consistent concern for the organization. While post-filing audits facilitate identifying non-compliant taxpayers, the process can be time consuming and resource intensive. Thus, it has aimed to reduce examination completion times, conduct examinations on a more current basis, and ensure consistency of issue resolution for all taxpayers. To do so, LMSB relied upon a risk based scoring system to identify returns suitable for examination.[13]

A. Large business and international

In August 2010, the IRS reorganized and renamed the Large and Mid-Size Business Division the Large Business and International (LB&I) Division. This reorganization of LB&I demonstrated the IRS's focus on international tax enforcement. International experts were consolidated under LB&I to streamline operations and dedicate more resources and expertise to international tax issues. Since then, the centralization of the international examination function and international tax expertise in LB&I has supported a focus on high-risk international compliance issues as well as greater consistency and efficiency.[14]

In addition, the new Deputy Commissioner (International) developed a foundational framework called the International Matrix to improve coordination of compliance strategies, collaborative networks, training programs, and data management efforts. The International Practice Networks (IPNs) consist of IRS employees that communicate with each other on the strategic issues that form the International Matrix. The goal of this program was to marshal IRS expertise to be more effective in determining which cases required the most attention.[15] LB&I's coordinated knowledge management efforts were a critical first step in creating a dynamic environment where agents are encouraged to identify issues and share their expertise.[16]

Currently, as part of its post-filing season activities, the IRS randomly selects some tax returns for audit and others based on scoring models. The IRS also utilizes technology-driven methods to verify the accuracy of certain tax positions taken on returns and to determine which returns to audit. An example is case assignment, where LB&I uses a point system to designate cases. Each case is designated through point criteria as

---

[13] Announcements, fn. 11.

[14] Internal Revenue Service, "IRS Realigns and Renames Large Business Division, Enhances Focus on International Tax Administration", IR-2010-88, August 4, 2010, available at http://www.irs.gov/uac/IRS-Realigns-and-Renames-Large-Business-Division,-Enhances-Focus-on-International-Tax-Administration

[15] Elliott, Danilack Reflects on Time at LB&I, Tax Notes, January 12, 2015, p. 175.

[16] Tax Management Transfer Pricing Report ("Tax Management Transfer Pricing Report"), March 20, 2014, p. 1, available at http://www.capdale.com/files/10660_Budget%20Woes,%20Mounting%20Demands%20Force%20IRS%20to%20Think%20Strategically,%20Focus%20on%20Training.pdf

either a Coordinated Industry Case (CIC) or an Industry Case (IC). The IRS analyzes returns of the largest business enterprises as part of the CIC program. The IRS assigns the CIC designation to large enterprises based on factors including the taxpayer's gross assets, gross receipts, operating entities, industries and foreign assets. IRS examiners continually audit CIC designated companies.[17]

LB&I also engages directly with taxpayers through programs such as the Compliance Assurance Process (CAP) to identify and resolve potential tax issues before a tax return is filed.[18] CAP helps the IRS identify those taxpayers with issues that require more review and benefit the more compliant taxpayer with a reduced level of annual audit. In CAP, LB&I employees work collaboratively with qualified LB&I taxpayers on a pre-filing basis, which results in shorter and narrower post-filing examinations.[19] CAP helps the IRS identify emerging issues at an earlier phase in the examination process, which may help the IRS direct resources to address these issues at an earlier stage of an audit. LB&I also has dispute resolution mechanisms such as Fast Track Settlement to assist in issue resolution.

B. Filtering and risk assessment

In February 2010, LB&I initiated a multi-year pilot to test whether a more comprehensive approach could be used to identify case selection. Under this approach, tax returns and specific issues are identified and selected for audit through issue filtering. They are then risk-assessed and assigned to an examiner to audit.

LB&I found multiple benefits to this approach including an increased ability to recognize areas of noncompliance. This method created a greater capacity for LB&I to timely respond to compliance risk by identifying and building cases with specific issues. In addition, it delivered higher risk cases through the application of rules and filters and upfront risk assessments. Such a centralized risk assessment process improves efficiencies and allows specialization, especially when coupled with collaboration through knowledge management structures.[20]

In 2012, as part of an effort to conserve resources and improve IRS case development and resolution, the IRS made efforts to further modernize its risk assessment capabilities. The acting Commissioner stated that the IRS wanted "to spend less time with compliant taxpayers" and "to reduce the time spent looking for issues and increase the time spent understanding and resolving them."[21]

---

[17] Dolores W. Gregory, Alison Bennett and John Herzfeld, "Tax Audits: IRS Move to End Continuous Audits May Rattle Some Taxpayers in Program." ("Tax Audits") Daily Tax Report, June 11, 2015.
[18] http://www.irs.gov/Businesses/Corporations/Compliance-Assurance-Process
[19] IRM 4.46.2.1, fn. 12. For more information on the Compliance Assurance Process, see http://www.irs.gov/Businesses/Corporations/Compliance-Assurance-Process-CAP-Frequently-Asked-Questions-FAQs
[20] IRSAC 2014, fn. 5, p. 46.
[21] Id. at 38.

LB&I's strong foundation coupled with its experience and expertise led to a cohesive and effective approach to international tax administration. The filtering and risk-assessment pilot demonstrated the potential of a system that developed a cadre of specialists who could build up their expertise in issues. The specialists could then develop rapport with subject matter experts in knowledge management structures and analyze the data collected.[22]

III. LB&I'S CHALLENGES IN TODAY'S OPERATING ENVIRONMENT

Similar to many other tax administrations, LB&I is facing challenges because of today's changing operating environment. In light of the growing number of increasingly complex and global filings, there have been additional global coordination efforts among tax administrations. These efforts will inform how LB&I operates in order to adapt successfully.

A. Complex filings

LB&I is facing a number of challenges including continued growth in the number of complex filings it receives. Under LMSB, widely promoted tax shelters created a race to the bottom for corporate and wealthy individual taxpayers, which resulted in a corrosive impact on the tax base of the US. By 2008, LB&I's efforts to combat offshore tax evasion often focused on specific situations identified by whistleblowers in the banking sector. LB&I is concerned with non-compliant activities undertaken by intermediaries promoting investments that would not be reported to the IRS by the foreign financial institution. As a result, LB&I has taken steps to encourage voluntary disclosure of unreported offshore income through the Offshore Voluntary Disclosure Program and subsequent voluntary disclosure programs.[23] Today, the IRS continues to uncover abusive tax-avoidance schemes involving offshore activity.[24]

In addition to the growing complexity of international tax, LB&I is facing increased compliance concerns regarding international behavior. In March 2010, the Foreign Account Tax Compliance Act (FATCA) was enacted into law. FATCA targets noncompliance by U.S. taxpayers with foreign accounts by focusing on reporting.[25] In 2013, the OECD/G20 initiated its Base Erosion Profit Shifting (BEPS) project, which consists of an Action Plan of fifteen items. The BEPS project includes the development of a Common Reporting Standard (CRS) and other Exchange of Information (EOI) efforts. The successful implementation of both FATCA and the BEPS project impacts how the IRS manages its human capital, information technology systems, forms, and internal processes.

---

[22] IRSAC 2014, fn. 5, p. 51.
[23] http://www.irs.gov/uac/Statement-from-IRS-Commissioner-Doug-Shulman-on-Offshore-Income
[24] http://www.irs.gov/uac/Offshore-Tax-Avoidance-and-IRS-Compliance-Efforts
[25] http://www.irs.gov/Businesses/Corporations/Foreign-Account-Tax-Compliance-Act-FATCA

For example, BEPS Action Item 13 focuses on the development of rules regarding transfer pricing documentation to enhance transparency for tax administration, while also considering the cost of compliance for businesses. These rules will require multinational enterprises to provide governments with information on "their global allocation of the income, economic activity and taxes paid among countries according to a common template."[26] Like the other Action Items, Action Item 13 will impact the nature and complexity of IRS activities. There will also be indirect results such as the need for more effective dispute resolution and tailored government mechanisms to facilitate the automatic exchange of country-by-country reports. Changes to exchange of information practices may lead to related exchange of information requests for additional specific or clarifying information. This could create greater demands on EOI programs.[27]

B. Budget constraints

Since FY 2010, the IRS budget has declined each year, even though the agency was required to assume greater responsibilities (such as FATCA and the Affordable Care Act), and it may be further reduced.[28] The IRS has 13,000 fewer employees than in fiscal year 2010, and is operating with a ten percent reduction of its 2010 budget. During the last five years, the IRS has saved $1 billion in efficiencies, but no longer has excess costs that it can eliminate to help it operate on this reduced budget.[29] These reductions have eroded the IRS's capacity to provide critical services for taxpayers, offer appropriate tax enforcement protections and plan for future improvements.[30] LB&I alone has experienced a staffing drop from 7,000 to 5,500 employees since 2010, which significantly impacts LB&I's operational abilities.[31]

With budget constraints reducing the IRS workforce by attrition and extremely limited hiring abilities, the need to rely on our current personnel has never been more evident. As a result, LB&I's approach has focused on achieving greater flexibility when deploying resources to accommodate the demands on LB&I.[32] When faced with a restricted ability to hire, it is critical to retrain and mobilize agents as quickly as possible.

---

[26] Organization for Economic Co-operation and Development, Committee on Fiscal Affairs, "Revised Final Consolidated Report on Action 13 of the BEPS Action Plan: Transfer Pricing Documentation and Country-by-Country Reporting", July 24, 2015.
[27] Koskinen, fn. 1, p. 6.
[28] IRSAC 2014, fn. 5, p. 10.
[29] Koskinen: IRS faces tough FY 2015 with budget, workforce woes, available at http://federalnewsradio.com/in-depth/2014/12/koskinen-irs-faces-tough-fy-2015-with-budget-workforce-woes/
[30] Koskinen, fn. 1.
[31] Tax Audits, fn. 15.
[32] Tax Management Transfer Pricing Report, fn. 16.

IV. THE PATH FORWARD: TRANSITION TO A FUTURE STATE

Moving towards a future state requires awareness that operational and procedural mechanisms have not yet been perfected. It also requires the leveraging of successful programs where possible. While in process, tax administrators need to reflect upon where they currently are and what they are moving towards in order to understand their path forward. The piloting of new projects, including an internal review of processes to identify strengths and weaknesses and the development of a knowledge management system, is moving LB&I towards a more dynamic and agile model. Through each of these activities LB&I has identified the need to deploy its most important resource, its own skilled personnel, against its highest risk areas. This section will highlight specific components of LB&I's operation that will help chart a new path forward.

A. Comprehensive Review of Existing Practices

To determine best approaches going forward, LB&I conducted a two part review. First, LB&I initiated a peer review of cases to evaluate existing examination practices and processes. This review of cases highlighted audit practices that were working, some requiring improvement and others that could be eliminated. Second, LB&I conducted a broader review of programs. Both sets of reviews identified a number of specific procedural changes that could improve overall LB&I operations. These changes include how LB&I engages with taxpayers through the Information Document Request (IDR) process, the effectiveness of the CIC designation process, and a review of LB&I's knowledge management framework. The reviews recommended an environment focusing on taxpayer motivations and risks and the development of processes that could be agile and modified to adapt to changes.

B. Understanding Taxpayer Motivations

LB&I has continued its attempts to understand and address taxpayer motivations. Recent changes in the Information Document Request (IDR) process demonstrate the benefits of improved taxpayer engagement and communication efforts. The IDR process is a structured formal process for requesting and receiving information from a taxpayer.[33] Improvements in the efficiency and transparency of the IDR process has led to an emphasis on the timely gathering of information and reducing the need to enforce the IDRs through summonses.[34] With meaningful communication between the IRS and taxpayers, enforcement procedures should be minimized.[35]

Prior to the issuance of an IDR, such communication would include the subject matter of an IDR, the information needed to evaluate the issue and why, what information the taxpayer has, the length of time needed to provide the information, and how long it will take the IRS to review the information. The new process involves graduated steps that

[33] IRM 4.46.4 (11-25-2011).

[34] http://www.irs.gov/Businesses/Large-Business-and-International-Directive-on-Information-Document-Requests-Enforcement-Process

[35] Id.

are aimed at including managers and Counsel early in the process. With this information the IRS can better manage field specialists, determine reasonable estimated closing dates, and reduce unproductive delays and waiting time. Taxpayers also benefit from targeted IDR requests that have reasonable time frames. Thus, promoting better dialogue between the two parties prior to the issuance of an IDR improves efficiencies for both parties.

C. Knowledge Management Efforts

By developing a foundation of knowledge management LB&I has also encouraged its employees to focus on taxpayer motivation and risks. LB&I's knowledge management program strives to ensure that every examiner approaches a case with accurate and comprehensive knowledge of the government's position on strategically important issues.[36] The main components of the program (strategy, networking, training, and data management) are aligned with the tax knowledge areas represented on the International Matrix.[37] The International Matrix provides the foundation for issue-focused efforts, which include International Practice Networks, International Practice Service, and International Practice Units. Each is designed to better reflect the behavior of taxpayers and focus audit selection and the examination process towards issue based activities. The underlying goal of these efforts is to marshal IRS expertise to be more effective in determining which cases have the highest compliance risk.

i. The International Matrix

The International Matrix organizes large areas of international tax knowledge into issues by considering the tax planning concerns of LB&I's taxpayer base. This has allowed LB&I to formulate a knowledge-based, strategic operating model. The International Matrix focuses on the areas where the tax stakes are the highest for a taxpayer, allowing an examiner to quickly identify the areas where audit time is most warranted.

The philosophy of the International Matrix is that audit selection and the examination process are based on issue identification. As a result, the International Matrix is developed around four core technical areas – business inbound, business outbound, individual outbound, and individual inbound. The Matrix is also an integrated whole with common underlying themes (i.e. jurisdiction to tax and income shifting) that pertain to more than one technical area. In addition, there are four cross-over areas that support all four core areas – Treaties, Information Gathering, Foreign Currency, and Organization/ Restructuring. The use of the Matrix supports an integrated approach to international examinations where international issues are analyzed in context and not examined in isolation.

---

[36] IRS Data Book 2014, fn. 3, p. 176.

[37] http://www.ey.com/Publication/vwLUAssets/EY-evolving-model-of-irs-examination/$FILE/EY-evolving-model-of-irs-examination.pdf

ii. International Practice Networks

International Practice Networks (IPNs) serve as the basis for knowledge management and networking. IPNs are employee communities that compile resources on broad areas of international compliance, including strategic issues. Each of the IPNs is identified on the International Matrix. Employees are empowered as subject matter experts through their experiences and encouraged to share their knowledge of issues with other employees. The IPN framework facilitates networking by providing the tools and environment for employees to broaden, enhance, and share expertise by teaching and learning from one another. To maintain oversight of IPN activities, a steering committee serves as a governing body for each IPN and provides a link between individual employees and the entire organization by communicating experiences and elevating concerns as appropriate.

iii. International Practice Service

The International Practice Service (IPS) was developed to organize and provide access to content to be used in training and as job aids. The IPS is an interactive website tool that is a central repository for the collective knowledge and expertise of an IPN. The IPS is a dynamic library of knowledge content mirroring the strategic priorities highlighted on the International Matrix. The IPS includes general information for those who are new to particular issues, as well as guidance to help in the identification of issues at the start of an examination.

The IPS has a searchable library containing relevant resources on a topic including audits tools, guidance documents, and training. The IPS serves as both a job aid and a platform for a "contextual" international training program that focuses on specific, relevant transaction-based guidance. As a result, the IPS is a centralized location to document and access information about international tax that promotes collaboration and further knowledge sharing.

iv. International Practice Units

To help distribute the collective knowledge of an IPN, LB&I developed “International Practice Units” that serve as both job aids and training materials on international tax issues.[38] The IPNs develop Practice Units through internal collaboration and field input. Practice Units are not official pronouncements of law but instead provide IRS staff with explanations of general international tax concepts, transactions or processes. There are four formats for Practice Units depending on the subject matter: general concept, overview of a process, detailed discussion of the steps for an audit process, or description of a specific transaction.

[38] http://www.irs.gov/Businesses/Corporations/International-Practice-Units

Practice Units provide a general explanation of how agents should think about that topic.[39] They depart from the traditional rule-based, Internal Revenue Code section-oriented training. Instead, Practice Units are just-in-time training focused on the scenarios and fact patterns an examiner may see in an audit. LB&I believes that if an agent understands the strategic picture of a transaction, he or she is more likely to ask the right questions upon audit. Practice Units are not static and the content and format will evolve as the compliance environment changes. All Practice Units are non-taxpayer specific; they focus on transaction scenarios and topics commonly encountered by practitioners. Each Practice Unit refers to additional resources to assist the employee in identifying and working the same or a similar issue in their own case. LB&I continues to develop Practice Unit modules to summarize existing knowledge. Practice Units are regularly shared with the public by being posted on IRS.gov.[40]

LB&I's ability to move forward will be based on the foundation it has laid through its reflection on existing practices, analysis of taxpayer behavior, and ongoing knowledge management efforts.

V. FUTURE STATE: RISK BASED EXAMINATIONS, PRACTICE AREAS, AND A HOLISTIC APPROACH TO TAX ADMINISTRATION

With the experience and knowledge it has gained over the past fifteen years, LB&I is now striving to further evolve by pursuing an operational model that ensures the deliberate allocation of resources through an emphasis on understanding taxpayer behavior. LB&I seeks to better describe and identify what constitutes both compliance and noncompliance in order to best distribute its resources. This process has involved self-reflection, a consideration of metrics, continued engagement with the taxpayer, and equipping employees with the tools needed to initiate and facilitate that engagement. In each of these steps, LB&I moves towards a better allocation of resources.

A. Risk-Based Examinations

Today, LB&I is moving towards business audits that narrow in on issues with the highest compliance risks. By continually updating risk-assessment criteria LB&I can keep pace with taxpayer behavior and ensure a more efficient use of limited resources leads to a high return on investment. Instead of relying on individual agents to determine compliance risk, the organization will have greater oversight on risk through a broader approach with multiple feedback mechanisms. LB&I can use information it receives to continually tailor its exam selection process to focus on current and future risk areas with critical issues.[41] LB&I is moving away from its historic CIC designation system and instead moving toward this broader risk-based approach to audit

[39] http://www.ey.com/Publication/vwLUAssets/EY-evolving-model-of-irs-examination/$FILE/EY-evolving-model-of-irs-examination.pdf

[41] http://www.irs.gov/uac/IRS-Releases-2006-Tax-Gap-Estimates

multinational companies.[42] This new approach will allow LB&I to consider additional factors beyond size so it can focus on the areas of noncompliance that merit the use of its limited employee resources. LB&I can then strategically determine if the taxpayer should be continually audited.[43]

B. Practice Areas

LB&I's future process requires constant feedback, an analysis of successes, and adapting to overcome limitations and address changes in the environment. Similarly, LB&I's knowledge management efforts such as the International Practice Networks and International Practice Service require feedback from participants to improve content. LB&I's Practice Areas, which currently include the Transfer Pricing Practice and Foreign Payments Practice, utilize field offices to facilitate interaction between examination teams and taxpayers. Practice Areas assist examination teams in case selection and development to "ensure optimal compliance impact" and the efficient resolution of disputes.[44]

Going forward, LB&I will expand the Practice Area concept to other areas. The Practice Areas will combine knowledge management efforts with programs focused on specific key initiatives. They provide the structure needed to obtain and process feedback from examiners on their observations of environmental changes and potential response mechanisms. Through the Practice Areas, LB&I can leverage its limited resources to focus on areas that will have the greatest impact and best utilize LB&I's employee knowledge. By encouraging review and reflection, LB&I has identified that an issue-based approach that focuses on taxpayer motivation and specific risks will ensure a better alignment of resources.

C. Campaign-Based Plan

LB&I is continuing to move towards an audit approach that emphasizes issues and compliance risk rather than taxpayer size. Today, successfully administering tax requires more than a strict focus only on taxpayer returns. Building on its knowledge management efforts, LB&I is looking for additional ways to address compliance risk beyond the limits of issues or returns. This campaign-based approach requires an analysis of broader environmental concerns, the identification of risks, and developing responses to those risks, including outreach and training. LB&I is building these efforts on the foundation of a knowledge management program that it has laid to mobilize employees around critical issue areas.

In the future, LB&I will consider multiple compliance approaches for issue areas so that it can focus limited and valuable resources on the right areas and drive a specific

[42] Tax Audits, fn. 17.
[43] Id.
[44] http://www.irs.gov/Businesses/Large-Business-and-International-(LB&I)-Division-Directory

compliance impact. LB&I may use alternative treatments in lieu of examinations such as “soft letters” to put taxpayers on notice, tax form changes, new guidance and practitioner outreach. Multiple approaches will be utilized and tailored to effectively ensure greater taxpayer compliance. Feedback from employees will be used to modify approaches as necessary to ensure the workforce is focusing on strategic areas.

Such efforts will extend beyond a single fiscal year and require a multi-year plan that can be revised and reviewed to adjust to compliance priorities as they arise. This will ensure that LB&I is structured around a planning process that adapts as lessons are learned. Employees will be able to quickly respond to changing facts and circumstances to ensure LB&I retains an agile approach to taxpayers. Employees will continue to identify issues they see in the field and develop their responses with the support of focused knowledge areas that govern how those issues are addressed by the organization. Employees will be focusing on where the risks arise as well as the size of risks and their frequency. These issues could be identified anywhere within the IRS. Thus, in this future state, LB&I will deploy employees against the areas of highest risk and re-allocate employees as those risks shift and change.

By taking a new approach to tax administration LB&I is utilizing lessons learned from its filtering and risk-assessment process and the establishment and growth of its knowledge management efforts to promote greater taxpayer compliance and adapt to its reduced resources. It will maximize its greatest assets, the employees, to navigate its future.

VI. CONCLUSION

The IRS’s focus on strategic approaches to international tax issues is a result of an increasingly complex, dynamic global environment as well as responding to the demand to do more with less. In an effort to maximize taxpayer compliance and the potential of its most valuable resource, its workforce, LB&I is shifting to an issue-based approach instead of its historical taxpayer-based approach. This shift has evolved from lessons learned through executive reviews of programs, pilot projects, and changes in taxpayer behavior. LB&I’s future path will continue to focus on risk assessment by building on its knowledge management foundation and by taking a holistic approach that focuses on taxpayer behavior and the strategic prioritization of issues. Only by carefully reflecting on its historical practices will LB&I be able to adapt and maximize its limited resources so it can adjust to today’s changing international tax environment and continue to focus on taxpayer compliance.

Topic 1.1

REVELOPMENT OF EXAMINATION PLAN; FOCUSING ON ISSUES TO BE REVIEWED AND INFORMATION SOURCES AND INTELLIGENCE

Jorge Rachid
Secretary
Federal Revenues of Brazil (RFB)
(Brazil)

Contents: 1. Introduction. 2. Tools – Information sources. 3. Examples to simplify ancillary obligations. 4. Results in 2014.

1. INTRODUCTION

The Inspection Plan of the Brazilian Federal Revenue is developed by means of the integrated action of the various areas coordinated by the Undersecretariat of Inspection.

The areas involved are the following ones:

a. Accompaniment of Large Taxpayers
b. Selection of taxpayers to be inspected
c. Inspection of previously selected taxpayers

Each area efficiently allocates their resources, aiming to achieve goals previously established. The most relevant strategic objective is to increase the taxpayers risk perception, as well as to strengthen the fiscal presence, especially by means of actions that massively use information technology tools. The goal is to promote auto regularization of tax obligations, either principals or ancillaries.

The working process of differentiated taxpayers accompaniment is structured in the following acting focus:

a) Tax collection monitoring;
b) Analysis of sectors and economic groups;
c) Priority treatment of tax liability.

In relation to the 2014 tax collection monitoring, in order to identify tax evasion evidences, tax collection distortions were investigated through the evaluation of tax returns provided by taxpayers, confronting them with external information. The effort related to this action fostered the recapture of almost R$ 5,3 billions of tax credits.

Regarding to the treatment of tax liabilities, this action is intended to give celerity and a conclusive treatment to the collection of formalized tax credits, tax credits under administrative and judicial discussion, as well as to large taxpayers compensations.

As a result of the continuous and close monitoring, were identified financial results arising from the conversion of legal deposits, payments and adhesion to installments in the amount of R$ 10,2 billions.

In this sum, R$ 4 billion are included which become to be additionally collected by taxpayers that were monitored in 2014 by the RFB.

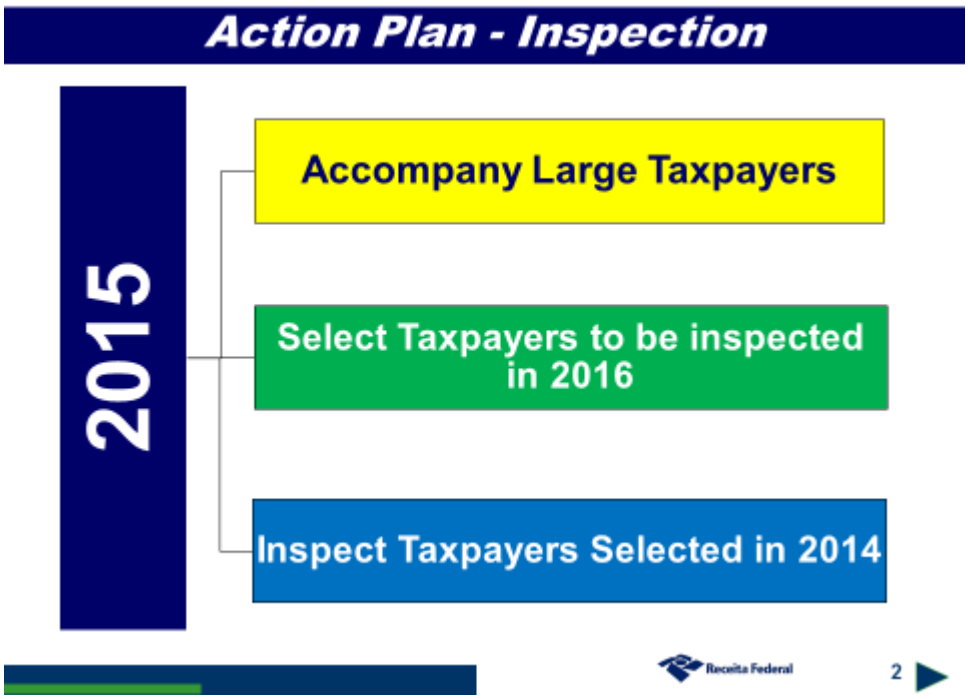
The working process of selecting taxpayers to be inspected is done on a regional basis, and shall be executed according to impersonality and objectivity principles, based on technical parameters and oriented to interest and fiscal relevance criteria. One inherent objective to the Inspection is to intensify the risk perception and the fiscal presence, aiming to increase voluntary compliance.

The specialization of this process leads to better results as far as the researches done by the responsible department allow the detection of new tax infractions modalities, the crossing of a large amount of information and an effective fight against abusive tax planning, usually performed by taxpayers with higher contributive capacity.

The working process of taxpayers inspection also focus on the spontaneous compliance and on rising the taxpayers risk perception. Moreover, it looks for the formalization of the tax credit recapture through the elaboration of notices of assessment, applying penalties.

As mentioned above, the three areas act in an integrated and coordinated manner, what can be exemplified by their temporal activities in the year of 2015:

a. The accompaniment of large taxpayers, acting closely to the Taxable Event, follows up the collection of the segment on the period of 2014 and 2015;
b. The Selection of Taxpayers identifies the taxpayers to be inspected in 2016 according to the crossing of information existent in the Federal Revenue databases.
c. The Inspection of Taxpayers in 2015 reaches the group that was already chosen in 2014, focusing on the year of 2012.



2. TOOLS - INFORMATION SOURCES

Tools - Inspection

3

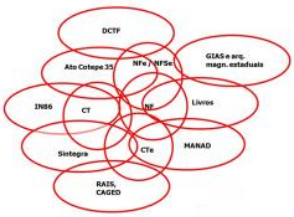
Tools - Inspection

Future Vision = All ancillary obligations captured by the SPED

6

Tools - Inspection

BEFORE



4

Tools - Inspection

AFTER

5

Public system of digital bookkeeping

With the Public System of Digital Bookkeeping (SPED), imposed by the Decree 6,022, January 22th 2007, the Federal Revenue of Brazil was definitely inserted in the Big Data era.

The request of ancillary obligations before the SPED were quite heterogeneous. Each tax administration of each Brazilian political entity established its own ancillary obligations without having to submit to any kind of coordination. It is a challenge for a country with more than 27 federated entities and more than 5000 municipalities.

Another factor that was hampering the control, the planning and the fiscal actions is related to the fact that each taxpayer's documentation was available in paper.

The SPED came to harmonize and simplify the provision of information. Ideally, it was sought the creation of only one tax document and one bookkeeping.

This pronounced simplification was not yet reached, but it is almost there. Currently, the system is composed by 5 tax documents, 7 bookkeepings, some still in formulation, according to the following table.

Tax Documents	Bookkeepings
Electronic Invoice (NF-e)	Digital Accounting Bookkeeping (ECD)
Consumer Electronic Invoice (NFC-e)	Tax-Accounting Bookkeeping (ECF)
Electronic Service Invoice (NFS-e)	Digital Fiscal Bookkeeping of Value-Added Tax on Sales and Services and Tax on Industrialized Products (EFD-ICMS IPI)
Electronic Bill of Lading (CT-e)	Digital Fiscal Bookkeeping (EFD-Contributions)
Electronic Tax Documents Manifest (MDF-e)	Digital Tax Bookkeeping System of Taxes, Social Security and Labor (eSocial)
	Digital Fiscal Bookkeeping of Withholding and Reports about Substitute Social Security Contributions (EFD- Reinf)
	e-Financial

The provision of information by SPED has definitely harmonized the data collection, jointing it with the Enterprise Resource Planning (ERP) of the taxpayers. On the other hand, it also opened doors to a huge amount of digital data.

Collect this data has become a relatively easy task and the numbers become impressive with the increase of enterprises and files computerization. Each year more than 2,5 billion of electronic invoice are generated and the base of these documents currently comprises more than 12 billion of electronic Invoice. The electronic bill of

lading base already exceeded 1 billion documents[1]. These numbers will be multiplied for 5 or 10 in the case of electronic service invoices and consumer electronic invoices (electronic service invoice and consumer electronic invoice), when those become widely used.

In its turn, the bookkeeping are other wide source of data. Only one of the tax bookkeeping, the EFD-Contributions, creates more than 2 million files per year and, when e-Social starts operating, it will monthly create approximately 300 million XML files, with labor, social security and tax events.

The SPED has become the gateway for legal entities data in the RFB and it has a future aim of eliminating all the ancillary obligations for taxpayers, in federal sphere, capturing all the information needed.

3. EXAMPLES TO SIMPLIFY ANCILLARY OBLIGATIONS

3.1 Corporate income tax return extinction

The Corporate Income Tax Return (DIPJ) and the bookkeeping of the Taxable Income Control Register (LALUR) in paper are no longer required in 2015, related to the triggering events that happened from January 2014. For taxpayers, the provision of information become more simple and direct, since it is now directly using its accounting for IRPJ and CSLL calculation, no longer needing double typing and checking.

From December 2013, this information's are transmitted to the RFB through the delivery of the Tax-Accounting Bookkeeping (ECF), which allows a better quality of the accounting information and its respective adjustments with tax repercussions.

The ECF made possible the extinction of DIPJ and LALUR in paper since 2014. The ECF can be delivered until the last working day of September 2015.

3.2 Electronic Invoice (NF-e): Eleven billion documents issued

The Electronic Invoice reduced the bureaucracy of operations involving merchandises and products in Brazil. Every month approximately 210 million Electronic Invoice are issued. Until today, 11 billion Electronic Invoice were issued.

Currently, there are more than 11 million establishments that emit electronic invoices and are exempted of maintaining heavy files structures and manual tax bookkeeping.

Since the electronic invoice implementation, it was prevented the cut of approximately 10 million trees.

[1] http://www1.receita.fazenda.gov.br/sped/. Access in 16 August 2015.

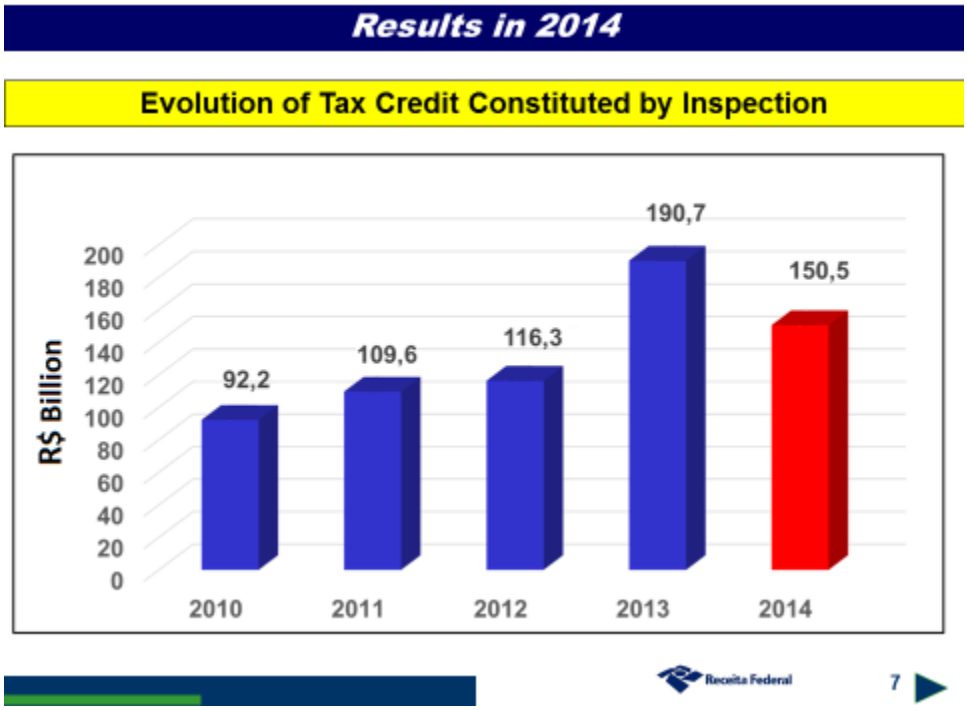
3.3 Consumer Electronic Invoice (NFC-e)

The Consumer Electronic Invoice is another simplification used by the Public System of Digital Bookkeeping. It is a document similar to the Electronic Invoice.

Designed for the retail business, consumer electronic invoice is in operation in 15 states of the federation and reached, in 2014, 100 million issued documents. For its hardware independence and simplified layout, consumer electronic invoice simplifies and makes the retail more competitive.

4. RESULTS IN 2014

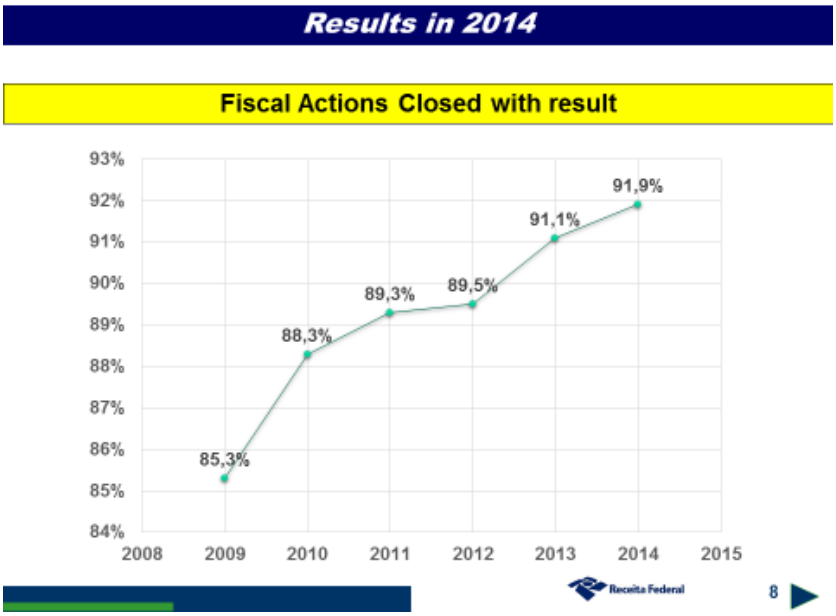
In 2014, the Inspection made by the Federal Revenue constituted the tax credit in the amount of R$ 105.5 billion. This value is the second higher obtained by the Revenue institution and it is only overcome by the value of 2013, when it was constituted R$ 190.1 billions.



4.1. Evolution of the inspection selection quality

The change on the strategy of selecting taxable persons (procedure done to identify who will be inspected), implemented in 2010, began to show results in this last multi-year cycle (2011-2014), allied with the process of Tax Inspectors continuous qualification and with intense use of technology allowed a constant improvement in the quality of the Federal Revenue Inspection selection.

The increase on the hit percentage in 6,6 percentage points in the period represented, in the year of 2014, the execution of more than 1.121 external audits with results.



The growth of notices of assessment assessed by RFB Tax Inspectors is explained, among others factors, as it was already mentioned in the commentary about the Working Process on Selecting Taxpayers:

- Improvement on taxpayers selection quality and on the detection of new tax infractions modalities.
- Huge amount of data crosschecking.
- An effective fight against abusive tax planning, usually performed by taxpayers with higher contributive capacity; and
- Specialization of audit teams and improvement on selection of taxpayers to be inspected.

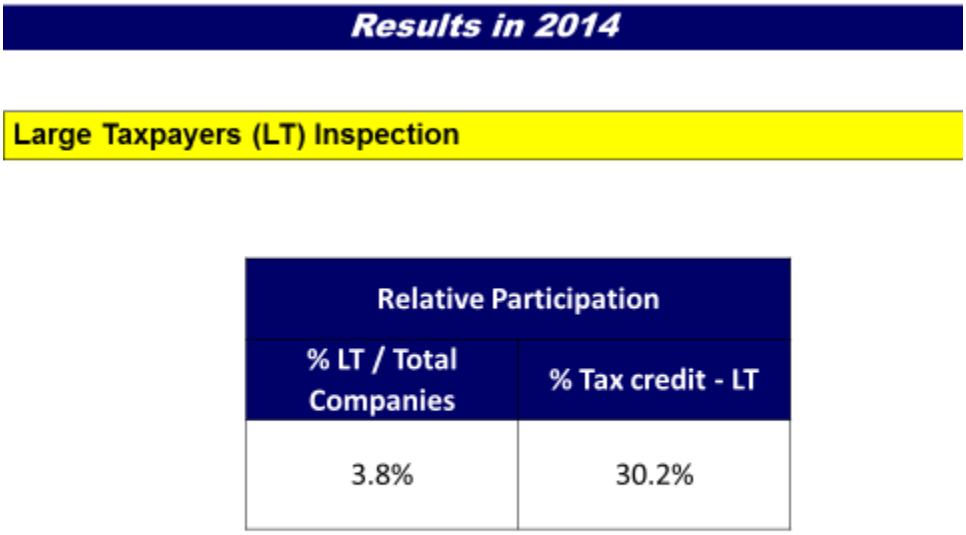
Results in 2014

Average Tax Credit constituted by a Tax Auditor of RFB

10

4.2 Large Taxpayers Inspection

The RFB specialized units in inspecting Large Taxpayers were responsible for R$ 43.5 billion, what represents 30.2% of the total recovered by the Revenue institution in



2014.

In the following table, the strategy used in the audits done by the Federal Revenue is evident, focused on taxpayers with higher contributive capacity, the ones who, in many occasions, use legal structures to elide tax payments, termed abusive tax planning. The participation of large taxpayers in the collection was of 65%.

Results in 2014

Large Taxpayers (LT) Inspection

Year	Large taxpayers participation in additional tax assessments
2009	60.9%
2010	65.4%
2011	72.1%
2012	79.6%
2013	84.1%
2014	71.6%

✓ ***65% of Federal Revenue***

Topic 1.2

THE POWERS OF THE TAX DEPARTMENT VIS - A - VIS THE TAXPAYER RIGHTS AND GUARANTEES DURING THE EXAMINATION PROCESS

Jarkko Orjala
Auditing Process Director
Finnish Tax Administration
(Finland)

Contents: Executive summary. 1. Introduction. 2. Tax audits in Finland: introduction and objectives. 3. Access powers, taxpayers obligation to keep records and disclose materials during an audit. 4. Other taxpayers' rights of special interest. 5. Conclusion.

EXECUTIVE SUMMARY

Taxpayers' rights are important in the Finnish taxation system and they are well respected. Also the morale of Finnish taxpayers to pay the right amount of taxes and willingness to handle their tax matters well is generally on a high level.

The Finnish Tax Administration performs different types of audits targeting all domestic and foreign legal and natural persons and their tax status. Over the course of last years we have come to realize that mistakes and omissions identified during real-time audits concerning an ongoing tax year can be voluntarily corrected already during the audit. Finnish legislation has adapted well to corrections that are made in common understanding with the taxpayer. Requesting a voluntary correction does not guarantee protection from criminal investigation or related sanctions. A voluntary disclosure program is planned for next year which would guarantee such protection but only when the Tax Administration has not already started investigating the matter.

The legislator has prioritized the access powers of the Tax Administration over rights that require information not to be disclosed. The access powers are wide and generally override any other secrecy, confidentiality or comparable restriction under Finnish law. However, challenges yet to be fully solved have been identified especially regarding electronic material (IT-forensics).

In addition to rights granted to the taxpayer, the taxpayer has also obligations. The taxpayer´s duty in Finland to disclose information for the purposes of a tax audit is extensive. The taxpayer must also help to settle matters during the audit to the best of his abilities. In the large majority of audits, the taxpayers diligently follow their obligations and operate in cooperation with the tax auditors.

A third party who receives an enquiry from the Finnish Tax Administration is required to provide the information needed for the taxation of another taxpayer. In the large majority

of cases all the requested information is given to the tax authority as requested. However, in rarer occasions problems may occur as is the case sometimes in acquiring tax planning memos from tax advisors. One such case has recently proceeded to the Supreme Administrative Court. In that case various rights have been invoked, for example obligations of the advisor in relation to the secrecy rules that it has agreed to follow, copyright, protection of property, right to perform business activities and whether control measures aiming to obtain such material are reasonable when considering the aim.

Comparative data audits are an effective way to gather information for taxation of taxpayers other than the target of the audit, and for purposes of target selection. They have been made, via a legislative change, possible also in the financial sector since 2011. Because on the enhanced protection of financial and personal data of taxpayers in the banking sector, some difficulties were at first encountered. Most of them have now been resolved. The information gathered from these sources has proven effective in tax auditing work.

In the current transparent global environment new ways to combat shadow economy at the expense of taxpayers' rights sometimes prevail, as is the case with the Finnish Public Tax Debt Register. These increases in transparency are seen as positive developments by the Finnish Tax Administration.

1. INTRODUCTION

Tax authorities in all jurisdictions must take into account the rights and guarantees granted to taxpayers especially when performing control of the tax matters of taxpayers. These rights are thus especially emphasized during tax audits, which are the most effective way of tax control.

This contribution focuses on introducing first the background on how a tax audit is currently performed in Finland and evaluates some of the most interesting rights and duties from the view of the taxpayer and of the auditor. Secondly the contribution presents case examples and comments on the latest main challenges that the Finnish tax administration has faced in connection to the taxpayers' rights.

The purpose of this contribution is neither to give a comprehensive general overview of taxpayers' rights and obligations nor the audit procedures in Finland but to underline the aspects that seem to be the ones surfacing when considering the current trends in Finland.

2. TAX AUDITS IN FINLAND: INTRODUCTION AND OBJECTIVES

Tax audits performed in Finland can target all domestic and foreign legal and natural persons and their tax status. Also a certain area, building site or other working area can be audited for purposes that include, amongst other things, identifying taxpayers.

The Finnish Tax Administration performs different types of audits. The audit can cover all the relevant taxes and recent years but more and more partial audits and otherwise limited audits are performed. Thus, only a certain transaction or certain type of tax can often be audited. The scope of the audit can be dynamically widened if remarkable mistakes are found during the process. The need to widen the scope rises if the mistakes are intentional and continuous.

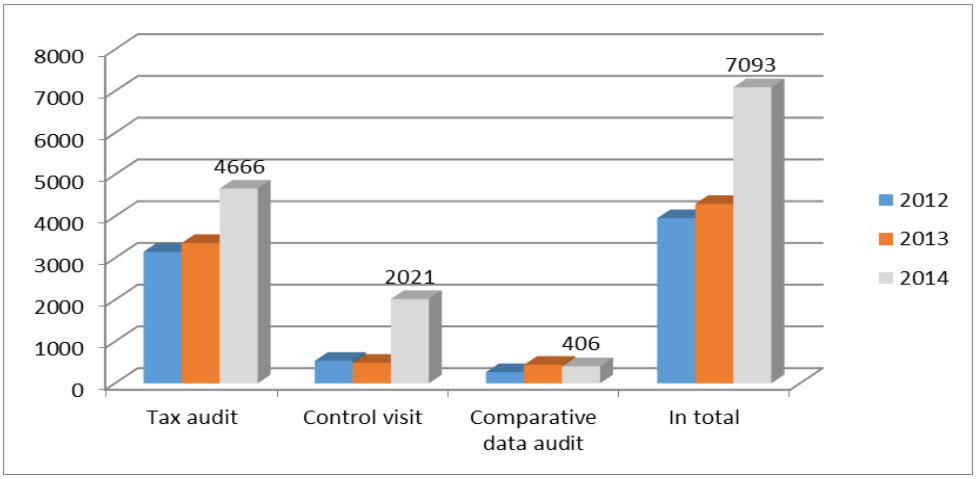
Over the course of last years, we have come to realize that mistakes identified during real time audits concerning the ongoing tax year can often be corrected already during the audit process. Finnish legislation has adapted well to corrections that are made in common understanding with the taxpayer: although there are no special legislation concerning voluntary corrections during audit the legislation normally allows the taxpayer to ask for a voluntary correction to their taxation, and according to taxation practice it has an effect to the compensation the taxpayer has to pay for the delay. In general the new approach has received positive feedback from the business as well as the auditors.

Asking for a voluntary correction does not guarantee protection from criminal investigation or related sanctions. However, the Finnish Government has planned to initiate a voluntary disclosure program next year, which would guarantee protection from criminal process but only when the Tax Administration has not started investigating the matter.

Besides taxation itself, during a tax audit a tax auditor can also inspect other matters within the Tax Administration´s competence, such as payment control, levying of tax and collection issues. The goal of tax audits is also to monitor the effect and operation of tax legislation and to provide a basis for proposed improvements to the existing legislation.

A general overview of the amounts control activities can be seen in the figure below. The amount of control visits is mentioned separately because they usually concern only performing a spot check on a specific issue and no tax auditing report is prepared unless the circumstances require.

Figure 1
Amount of control measures 2012-2014



A tax audit may be carried out simultaneously with the actions undertaken by other authorities, for example in shadow economy audits the tax auditors often cooperate with the Finnish Police or Customs. However, the auditor always acts under the powers granted on him by the tax legislation.

An important aspect to note is that the Finnish Tax Administration does not conduct criminal investigation. Any suspected tax fraud or other suspected crimes are reported to the Finnish Police or Customs, and that authority conducts the criminal investigation. The cooperation with the other authorities in Finland works very well. The Finnish Tax Administration can give expert support in tax issues also during the criminal investigation if it is required by the other authority.

Issues related to criminal investigation are not covered in this contribution but it should be noted that according to the current interpretation, the right to self-incrimination is not present during tax audits unless the Police or Customs has initiated a criminal investigation regarding the same taxpayer.

3. ACCESS POWERS, TAXPAYERS OBLIGATION TO KEEP RECORDS AND DISCLOSE MATERIALS DURING AN AUDIT

3.1 Access powers

In Finland the legislator has decided that in most cases the access powers of the tax administration must prevail over private interest of keeping information confidential. The access powers of the Finnish Tax Administration are provided under Act on Assessment Procedure. The access powers are wide and generally override any other secrecy, confidentiality or comparable restriction under Finnish law. They allow the Tax Administration for example to obtain information held by banks and other financial institutions as well as information concerning the ownership of companies or the identity of interest holders in other persons or entities as well as accounting information with respect to all such entities.

Example 1: challenges in gathering digital material without the consent of the taxpayer

Finnish legislation does not currently allow the tax administration to perform IT forensics (e.g. directly gathering data from a company by using a technical device without the consent of that company), without involving the Police. Therefore, the practical work can be challenging as evidence of a crime is first needed and the resources of the Police have to be taken into account. This has been identified as a shortcoming in the digital era and the Finnish Tax Administration is working to improve the situation by influencing legislators and gathering proper knowledge of these issues.

3.2 Taxpayers' obligation to disclose information

The taxpayer´s duty in Finland to disclose information for the purposes of a tax audit is extensive. Besides actual accounting records, all other material and assets that might have a bearing on taxation must be disclosed. The tax auditor decides what these materials and assets are[1]. Material stored in electronic form is also subject to disclosure.

The taxpayer must also help to settle matters during the audit to the best of his abilities. The principle is that the party in the best position to provide clarification in resolving an issue must do so. If the other party to legal action taken by a taxpayer does not live in Finland or has no residence in Finland, and the tax authorities are unable to acquire sufficient information on the legal action or the other party under an international treaty, the taxpayer is generally liable to provide clarification.

Accounting records and other material subject to disclosure must be provided for the tax audit even if they contain confidential information from the taxpayer´s point of view.

It can be concluded that the large majority of audits, the taxpayers follow their obligations and operate in cooperation with the tax auditors. However, one example situation where problems can occur is presented below.

Example 2: practical problems in relation to taxpayers' obligation to be cooperative and to provide accurate information and documents in time

Some issues have been identified concerning the extent of taxpayers' responsibility to disclose material during audits. In practice, these responsibilities and their relation to taxpayers' rights allow at times for uncooperative taxpayers to cause high amounts of additional work and to delay the audit process.

When a taxpayer or third party is not willing to disclose certain materials, the Finnish Tax Administration would first give a written notice to disclose the material. The

[1] However, a fresh Administrative Court decision indicates that this right is not without its limitations. See case-example par 4.3.

taxpayer cannot appeal the notice in most cases[2] but a third party has always the right to appeal to the administrative court. These rights can cause major delays in the audit schedules. Research conducted by The Finnish Tax Administration shows that the risk of a tax is not being eventually collected rises the longer the audit takes.

It can also be an issue that a Finnish tax auditor is not entitled to gather materials from the premises of the taxpayer without the consent of the taxpayer (in Finland the Police is always needed in these cases). Therefore, the tax auditor does not necessarily, without the active cooperation of the taxpayer, have a possibility to know which materials are available and should normally be disclosed.

It can be concluded that the possible disputes seem to progressively concentrate on the procedural requirements of the audit or at minimum such matters are more often raised together with the tax-substance questions. Legislation allowing sanctions for obstruction of the audit used in some jurisdictions could be beneficial in these cases. An optimal system would offer protection to the taxpayer when the interest is valid and would punish for conduct which is aimed solely for hampering the audit.

3.3 Tax Administrations' obligation to disclose auditing materials to the taxpayer

As a general principle, every taxpayer is entitled to all the documents and other information that has affected or could have affected the decision making in his tax case. This principle also applies during audits.

Without going further to the details in these cases, it can be said that a trend can be identified during the last years that some taxpayers demand access to more and more materials that are not the "core" elements in the audit. This trend has been especially identified in transfer pricing audits. Processing extremely wide requests consumes a high amount of resources, and possible disputes have to be sometimes settled in Administrative Court.

3.4 Third parties' obligation to disclose information

The recipient of an enquiry from a tax auditor (or other official of the Finnish Tax Administration) is required to provide the information needed for the taxation of another taxpayer. The matter enquired about is specified so that the necessary information can be provided. The information requested might sometimes concern a matter on which testimony need not be given by law. However, according to Finnish law this information must be provided if it has a bearing on taxation and is financial in nature.

Authorities and other public bodies may also be asked about information in connection to a tax audit. The information requested may at times be covered by the authorities´ confidentiality duty, but in most cases Finnish law contains a special provision about

[2] In some cases however, the Finnish Administrative court has approved appeals that relate not to the disclosure itself but the scope of the material that would be required to be disclosed.

disclosure from a certain authority to the Tax authority and vice versa. Again, if the information has a bearing on taxation and is financial in nature, it must always be provided.

Under EU-law and agreements that allow tax information to be exchanged, information may also be obtained from and given to the tax authorities of other jurisdictions.

Case A: a memo prepared by the tax consultant of a company under audit

The Finnish Tax Administration had requested the tax advisor (a company offering audit and tax planning services) of a company under audit to disclose a memo prepared for the purposes of tax planning of the company. The existence of the memo was identified from the receipts included in the bookkeeping of the company. The company audited was operating in the payday-loan sector. The memo was requested from the advisor because the taxpayer refused to provide the memo to the tax auditors.

According to the Tax Administrations view, the memo could have contained relevant facts and it would have shown what kind of knowledge the owner of the company had about the company's business when he decided on how to arrange the tax matters of the company. Knowledge about the information that the owner had would have in turn affected how punishable the omissions detected during the audit were. Additionally, the memo was needed to estimate whether the expense in the bookkeeping of the company was acceptable.

The Administrative Court decided the case in favor of the tax advisor. According to the Court "The obligation to disclose information by a third party concerns only information which could be required to process the tax matter of a taxpayer. The Tax Administration can only request to disclose materials that contain information on the actions of the taxpayer which have an effect on the tax liabilities of the taxpayer. Such information can be found from the bookkeeping materials and other materials concerning the business activities. The memo prepared by the tax advisor contains only opinions and those opinions are not relevant facts which affect the tax liabilities of the taxpayer." The Court also stated that disclosure of the memo would violate the obligations of the advisor in relation to the secrecy rules that it has agreed to follow, copyright, protection of property, right to perform business activities and that the measure itself is not reasonable when considering the aim.[3]

An appeal is currently pending in the Supreme Administrative Court. The decision can have a larger impact on the disclosure obligations of tax advisors concerning their tax planning memos.

[3] Administrative Court of Helsinki 25.06.2014, case 14/0570/6.

3.5 Comparative data audits

A very important tool for acquiring information for audits and for target selection is the possibility to perform an audit for the sole purpose of obtaining comparison data for the taxation of other taxpayers. These kinds of audits are performed to similar scope of persons than tax audits but the purpose is different. The “targets” or the information that will eventually be collected are not required to be known beforehand.

An important change was made in the beginning of 2011, when the limitation which denied the Finnish Tax Administration to perform a comparative data tax audit on financial institutions was removed. The practical details of such audits are explained in case B.

Case B: comparative data audits in the banking sector

As stated in the last section, comparative data audits targeting the banking sector have been possible since 2011. By conducting such audits in the banking sector, the Finnish Tax Administration aims to collect non taxpayer specific data with the aim to find targets to be audited. For example the Tax Administration can request to disclose information e.g. considering transfers of money to certain low tax jurisdictions. The collected information is checked against the information already in the possession of the Tax Administration.

However, as the new legislation was not very detailed, some problems were encountered. A lot of critique was first received from the banks towards the costs of acquiring the data. Finnish legislation does not stipulate anything on costs in relation to third party’s obligation to provide materials to the Tax Administration. Therefore, the costs should be always borne by the business and seen as a part of normal operating costs.

While keeping the critique mind, the Tax Administration aimed at first to obtaining the whole customer register of a bank in order to minimize the workload and costs of the bank in gathering the information. Eventually it was identified that this was the wrong approach because the Data Protection Ombudsman (by request of one bank) stated that the request should be more limited. Thus, the request was prepared in more detail.

Soon after this phase the Bank appealed to the Administrative Court. Eventually in 2014 the Administrative Court of Helsinki found that neither banking secrecy nor protection of personal information of the persons relating to the requested data would affect the banks obligation to disclose the requested information to the Tax Administration, and denied the appeal of the bank. The costs of gathering the data would also have to be borne by the Bank.

The results of making use of the data obtained are initially very promising in e.g. foreign transactions project and e-commerce project.

4. OTHER TAXPAYERS' RIGHTS OF SPECIAL INTEREST

4.1 Informing the taxpayer about the tax audit and the right to be heard

According to good Tax Auditing practice taxpayers are normally informed in advance about the audit. If possible, taxpayers´ wishes are taken into consideration when the decision is made on when to begin the tax audit. When there is a special reason[4], a tax audit can also be carried out without advance notification.

During tax audits the right to be heard is of special importance. Already during the audit the taxpayer is given a change to comment on the identified aspects that can lead to changes in the taxation of the taxpayer. As statutory requirement and before the final tax audit report is compiled, the taxpayer must be provided with an opportunity to explain his position within a reasonable period of time. This is known as the right to be heard and it means that the taxpayer is given an opportunity to express his viewpoint or give further explanations. Taxpayers must always be given the possibility to be heard when the tax audit report proposes taxation or debiting measures, or includes information or gives instructions of which the taxpayer´s opinion is required.

It should be noted that the mechanics of the right to be heard were simplified in October 2014 when a legislative change did not anymore require the hearing of the taxpayer on the preliminary tax audit report. The issues identified are resolved already during the audit in cooperation with the taxpayer. The change has gained positive feedback from both the business and the auditors and saves resources by making the auditing process more effective.

4.2 Taxpayers' right to privacy and secrecy and the Finnish public tax debt register

All information which relates to an identifiable taxpayer and is in possession of the Finnish Tax Administration is covered by secrecy rules. A notable exception is the income information of all Finnish residents published once every year and the information in the public business register (https://www.ytj.fi/english/)

The latest change in this area, which diminishes the protection of the taxation information of individual taxpayers, is the public Tax Debt Register. The Finnish Tax Administration launched the Register in December 2014. The Register is an online service allowing anyone to make enquiries on outstanding tax liabilities and negligence in tax return filing of all types of companies and self-employed businesses (with tax debt exceeding 10 000 euros). The need to weed out shadow economy and willingness to increase openness in society led to the establishment of the register and thus to the loosening of the secrecy of the tax-information concerning tax debts. The Register

[4] Such special reason can be for example high risk of tax loss or that the purpose of the audit will be endangered if the taxpayer is informed beforehand. If there is a suspicion of criminal conduct present, often the right procedure is chosen together with the Police.

works as an incentive for compliance with reporting and payment obligations. A clean Tax Debt Register entry is a proof that one's obligations have been sufficiently met.

The Tax Debt Register has proven user-friendly for the customers. The feedback received showed that the service was well received and easy to use. The tax.fi website was used effectively to guide customers into using the service. The Register also attracted a lot of media exposure which also helped to raise its profile.

5. CONCLUSIONS

The powers of the Tax Authority in Finland are extensive and for the most part seem to be in balance with the extensive rights granted to the taxpayer. It is crucial for the functioning of the whole Finnish tax system that the morale of taxpayers in general to pay the right amount of taxes and to handle their tax matters well is on a high level. Therefore, to enhance compliance the Tax Administration can concentrate on giving guidance to the taxpayers. More and more guidance is given also during tax audits and regarding real time audits, the option to correct mistakes voluntarily has been well received.

Issues can arise with uncooperative taxpayers and challenges have been identified for example regarding the sufficiency of the tax authority's access powers to digital materials and to the tax planning documents. Recent experiences also indicate that the procedural requirements of the audit are progressively disputed by some taxpayers. It is clear that taxpayers' rights must be respected but on the other hand these rights should be balanced against the valid public interests especially during the auditing process. The rights should not be misused in order to hamper the auditing process and legislation should sufficiently support this approach.

The possibility to conduct tax audits to gather comparative data is a great benefit in tax auditing work. With the latest change to allow performing audits in financial institutions in 2011, useful materials have been obtained after clearing the shortcomings in the beginning of the process.

With the budgets of jurisdictions being at stake new ways to combat shadow economy at the expense of taxpayers' rights sometimes prevail, as is the case with the Finnish Public Tax Debt Register. With the electronic statewide central income register in the making, the Finnish Tax Administration welcomes the new open and transparent environment into tax matters in Finland.

Topic 1.4

THE CONTROL OF WITHHOLDING AGENTS

José Antonio Bianchi
Deputy General Director of Collection
Federal Administration of Public Revenues
(Argentina)

Contents: Executive summary.1. Introduction. 2. Legal nature of the Withholding Agents. 3. Why do withholding and collection agents exist? Objective. 4. Statistical data. 5. Regulatory standard – Filing and deposit procedure. 6. Negative externalities of the withholding at the source system. 7. Control scheme of the withholding at the source system. 8. Conclusion.

EXECUTIVE SUMMARY

Withholding at the source consists of the advanced collection of taxes which individuals making payments are obliged to retain, given the closeness of the source of wealth to the taxpayers paying capacity, with the latter being the cause of the tax. Withholding is thus understood as the duty of collaboration of a noncontributing individual –regarding a specific taxable event- with the Treasury, which involves the act of withholding and the obligation of depositing the withheld amount in the public treasury.

The Withholding Agent is the one who, on being a debtor or exercising a public function, an activity, trade or profession is in contact with the sum of money which, in principle, would correspond to the taxpayer and, accordingly, may reduce the part thereof that corresponds to the Treasury by way of tax and depositing it at the order of said creditor.

The establishment of every withholding or collection system involves in itself a series of constitutive or motivating elements which, for purposes of theoretical simplification consist of: a) trust in specific agents; b) collection issues; c) examination issues; and d) taxpayers from abroad.

In the withholding at the source system the first aspect to be considered for exercising an appropriate control is to generate a “conflict” between the Withholding agent and the one from whom the retention is made, in such a way that if the latter has a document that proves the collection made, it is also important to visualize the behavior of the Withholding Agent with respect to the part of “his” tax which he took charge of.

If we were to follow a logical sequence, the second level of control would be to oblige those from whom withholdings were made, to use the amounts that were retained according to the information existing in the data bases of the Tax Administration and

which comes from the information provided by the Withholding Agent. Obviously, this process should allow claims of those from whom withholdings were made given the nonobservance of th rules by the Withholding Agents.

The third, and perhaps the last stage would be the computerized systematization of the entire witholding process, where the Withholding Agent may enter a site of the Tax Administration to obtain the withholding certificate and automatically said certificate generates the credit balance in the account of each Individual subject to Withholding.

The path that should be followed by the Tax Administrations to avoid fraud in the withholding at the source system is the path of functional and computerized integration of all the procedure that should be followed by those who must act as Withholding Agents, with special emphasis on closing the life cycle of a withholding.

1. INTRODUCTION

The control of the withholding agents is a challenge that involves all the Tax Administrations, since any illegality incurred in the withholding at the source system causes a decrease in collection.

As we will analyze “infra”, many are the virtues that surround the withholding at the source system, among them, that of controlling an important percentage of collection through few taxpayers, indirectly examining the activity of a significant number of small taxpayers, which if said scheme would not exist they could be left –through their own decision – outside the scope of the taxes.

It is necessary to analyze the legal nature of the creation of the withholding agents and the objectives pursued by such a scheme, to then undertake the analysis of the negative externalities which it generates.

These externalities must be analyzed in detail and faced by the Tax Administration with integrated computerized tools that may imply for the intervening parties the perception of risk of being detected and sanctioned for the maneuvers carried out.

The details of the computerized tools constitute the basis of this paper, since this will allow for setting the path to be followed by the Tax Administrations in combatting fraud by the withholding agents.

2. LEGAL NATURE OF THE WITHHOLDING AGENTS

The legal relationship arising as a result of the event provided by law as presupposition of the tax obligation, involves an objective as well as a subjective aspect, it being important –in this case – to examine the latter.

The tax authority and the taxpayer in this relationship are linked by the factual circumstances determined by law, in such a way that when they actually take place, the tax claim will originate for the first one (tax authority) and for the second one (taxpayer), the corresponding debt. Now, for several reasons it could happen that the legislator may place "next to or instead of" said taxpayer, someone else obliged to comply with the tax payment, but who is unrelated to the definition of the taxable event.

Taxpayers are the individuals with respect to which the factual presupposition of taxability, known as "taxable event" is verified. On the other hand, those jointly responsible are those who, although unrelated to the taxable event, but placed by the legislator next to the taxpayer, formalize a relationship, where both of those obliged, indistinctly coexist. The substitutes are those who, while also being unrelated to the taxable event, according to the law, replace the taxapyer in the tax relationship.

The tax legislation (Law N° 11.683, t.o. in 1998 an its amendments, hereinafter LPT), reminds the withholding and collection agents their capacity as jointly responsable agents.

The Withholding Agent is the one who being a debtor or exercising a public function, an activity, a trade or profession is in contact with an amount of money which, in principle, would correspond to the taxpayer and, accordingly, may deduct the part thereof that corresponds to the Treasury by way of tax, and depositing it at the order of said creditor.

The Collection Agent, on his part, is the one who because of his profession, trade or activity receives from the taxpayer an amount of money to whose original amount one should add the tax that will subsequently enter the Treasury.

The withholder, then, must always deliver or in some way participate in the delivery of an amount of money to the legal recipient of the tax, which circumstance allows him to "deduct" the amount corresponding to said tax. The collection agent, instead, considering that generally he provides or transfers a good or service to that recipient, obtains from the latter a price to which he "adds or sums up" the tax amount.

In this respect, it was stated: "…With respect to the collection agent and in the most common hypotheses, he is the one who receives money from the taxpayer and to that money, he adds the amount of the tax (that is, he practices the mathematical operation of addition). On the other hand, the withholder is the one who delivers money to the taxpayer (or enters in direct contact with said money) and from those funds, he extracts the tax (that is, he practices the mathematical operation of subtraction)…"[1].

[1] Villegas, Héctor B. "Los agentes de retención y de percepción en el derecho tributario" – Bs. As. 1976 – pág. 257.

In sum -according to the statements by Osvaldo Soler- in keeping with the tax law, the withholding at the source is the advance collection by way of taxes which those making payments are obliged to retain, given the closeness to the source of wealth, showing the taxpayers' payment capacity, with the latter being the basis of the tax. Thus, the withholding is understood as the duty to collaborate with the Treasury by a non-taxpaying individual –with respect to a specific taxable event, which results in the act of withholding and in the obligation to enter the amount withheld in the public treasury.

3. WHY DO WITHHOLDING AND COLLECTION AGENTS EXIST – OBJECTIVE

Following the conceptual description of the legal nature of the withholding and collection agents, one must now consider the elements that served as theoretical and factual basis for the creation of this legal norm in each of the taxes.

First of all, it is convenient to synthesize the advantages of establishing withholding at the source systems[2]:

1.- The taxpayer does not "visualize" the effect of the tax in the transaction.

2.- The taxpayer feels that the tax is less severe, since he is deprived of an amount that was never available to him.

3.- Withholding is a very effective element for combatting fraud. Small taxpayers who perhaps by themselves wouldavoid taxation, are forcefully subject to the system without the slightest possibility of evading.

4.- Tends to increase tax collection.

5.- Avoids the disbursement of large sums of money by the taxpayer and the resulting drastic decrease in consumption and expenses during the period when he must pay the totality of the tax.

6.- Decreases the costs of the Tax Administration.

7.- Facilitates the identification of the taxpayers which, if the withholding of the source system would not exist, could continue to be ignored and evading their tax burden.

8.- The Tax Administration receives the revenues prior to the date on which it would do so if the taxpayer would make his payments in the periods when he would have to pay, if there were no withholding.

9.- It allows for collecting taxes from taxpayers from whom it would be difficult and at times impossible to act coercively (taxpayers domiciled abroad).

[2] Villegas, Héctor B. , op. cit., pág. 17.

10.- Verification is simplified, since the number of those obliged is significantly lower.

11.- The Tax Administration ensures a higher level of tax payment, since the economic solvency of those appointed as withholding agents is general greater tan that of the taxpayer.

The establishment of every withholding or collection system involves, in itself, a series of constitutive or motivating elements, which –for purposes of theoretical simplification may be grouped into: a) trust in specific individuals; b) collection issues; c) examination issues; and d) taxpayers abroad.

3.1 Trust in specific agents

The Tax Administration (hereinafter TA) specifically designates a group of tax agents, who because of their economic scope represent such a solvency that ensures the collection of the taxes owed.

Thus, those agents designated by the TA who carry out economic transactions with individuals other than those mentioned (who represent a greater risk for the TA or, in some cases, less solvency to pay the taxes incurred), are in charge of "withhodling" part of the tax incurred in said transaction and to enter it in the Treasury.

In this way, the TA ensures the entry of a significant percentage of the tax earned. This type of withholding system is generally used in consumption taxes.

A second form of this characterization –although also present in the following section – is the simplification which it represents for the TA, on controlling a significantly smaller number of taxpayers. As an example one may point out some data that show this reality: 18.231 agents made Value Added Tax withholdings in 2014 to 1,474,780 taxpayers.

3.2. Collection issues

At other times, the individuals intervening in the transaction are not as important, but rather the objective of ensuring revenues for the State leads to the establishment of "withholdings" or "collection", which on being entered in advance to the integration of the taxpayer's fiscal period, allows the State to count on the necessary resources for its development.

Systems with this objective are mainly found in direct taxes, since the fiscal period tends to be anual with the earning of income throughout the year, which leads to entering part or all of the tax well in advance.

One may analyze the case of withholdings made on the fees of liberal professionals who are affected by the tax (through withholding) when issuing every service voucher,

while having to file the corresponding sworn declaration and paying the amount owed, only once, on the the year following the closing of said fiscal period.

At other time, this type of systems are used to collect from financial transactions, either through withholdings or through systems for collecting in bank accounts.

The income tax withholding from employees in a dependency relationship, constitutes, from a quantitative analysis, the main source of advanced revenues.

3.3. Examination issues

There are other withholding systems that do not involve such issues as collection or verification of simplification, but are rather established for carrying out “ex ante” and “on line” controls of specific tax events. These types of systems are generally established in activities with high evasión indexes.

By way of example, below is a description of the use of this mechanism in the grain marketing activity. The bases of the scheme are the following:

a.- Fiscal Registry of Grain Traders.
b.- Withholding System
c.- Withholdings Refund System

Basically, all primary grain sale transactions are subject to a withholding equivalent to 80% of the value added tax thereon (average percentage applied to the transactions). Subsequently, a crosscheck of the transaction is carried out between the producer (VAT sworn declaration), the purchaser (generally the stock, sworn declaration of Withholdings) and the registration of the producer in the Fiscal Registry of Grain Traders, from where it follows that if the transaction is correctly registered by all levels intervening therein and the amount has been entered in the Treasury, the latter returns to the producer around 90% of the originally withheld amount. If the crosscheck is not satisfactory, the refund is not made, and the financial cost thereof must be borne, since it is a very high withholding, in most cases a balance will be generated in favor of the producer which he will maintain immobilized for a long time.

From the above description one may observe the advantages of implementing this type of withholding systems where all the transactions are under the TA’s control, before the taxable event takes place and at the very moment it is taking place.

3.4 Taxpayers from abroad

Finally, there are systems established for collecting taxes from individuals living abroad and which because of their activity in the country –even though sporadic – become taxpayers.

These systems are present in income tax and are applied through the adoption of the world income criterion for allocating the profits. In general, it is a criterion whereby the local resident pays taxes for his profits and the foreigner for that obtained in the local territory. The tax withheld in a country is a tax credit in favor of the taxpayer in the state wherein he declares his income.

Thus the objective is clear and that is the collection of income tax to residents abroad for income obtained in the country. It is for this reason that whoever makes the payments is obliged to withhold the amount of tax that must be paid for said transaction.

4. STATISTICAL DATA

4.1. Collection

In 2014, income from withholdings amounted to $ 295.667 million, thereby representing 25.3% of the tax resources obtained in the aforementioned year.

Retenciones impositivas, aduaneras y de los Recursos de la Seguridad Social

Recaudación año 2014

En millones de pesos

Concepto	Importe
TOTAL RETENCIONES	**295.667**
IVA	116.904
Impuesto a las Ganancias	165.836
Contribucones a la Seguridad Social	10.945
Bienes Personales	1.070
Imp. Transf. de Inmuebles - Ley 23.905	912
A los Premios de Juegos - Ley 20.630	436

Of this, 56.0% corresponded to withholdings of Profit Tax, 39.5% withholdings of VAT and 3.7% to Social Security Contributions. The rest of the systems contributed 0.8%.

In the first semester of the current year, collection from withholdings achievedf an interannual increase of 31.6%, in keeping with the increase in total collection that amounted to 31.3% in that period.

4.2. Withholding Agents and those Subject to Withholding

In 2014, the VAT withholding agents were 18,231, while those subject to withholdings amounted to almost 1.5 million taxpayers. During that period, the Profit Tax withholding agents amounted to 135,929, and those subject to withholding were 5.1 million.

Retenciones impositivas, aduaneras y de los Recursos de la Seguridad Social
Agentes de retención y retenidos - Año 2014
En casos CUIT

Concepto	Agentes de retención	Cantidad de retenidos en el año
IVA	18.231	1.474.780
Impuesto a las Ganancias	135.929	5.130.768
Contribuciones a la Seguridad Social	19.734	100.649
Bienes Personales	1.582	306.128
Imp. Transf. de Inmuebles - Ley 23.905	8.338	248.507
A los Premios de Juegos - Ley 20.630	100	62.714

5. REGULATORY STANDARD – FILING AND DEPOSIT PROCEDURE

According to the regulations of the TAs, the withholding agents that must act as such must provide the names and enter the withholdings and/or collections made according to the following guidelines:

1. Enter the total amount of withholdings made from day 1 to 15, both inclusive, of each month, until day 25 of the same month, according to the termination of the CUIT.

2. Report by name the withholdings and/or collections made during the course of the calendar month, and enter the resulting balance of the sworn declaration, until the day of the immediately following month determined by the AFIP schedule.

The information by name referred to in the previous paragraph 2), and global determination with respect to each of the taxes refered to in the regulatory standard, as well as the respective monthly sworn declaration must be made through the “SICORE – Withholdings Control System”. It is a desk application without any connection to the TA. The only point of contact is the file that generates the application that must be submitted –by Internet- to the TA.

When making the withholdings and/or collections, those responsible must provide to those subject to the withholding:

1. For the withholdings: a “Withholding Certificate”, with the data which, depending on whether it is a taxpayer subject to withholding with domicile in the country or abroad, are included in the models of the general resolution. The Withholding Certificate may issued through the application program, with the pre-numeration corresponding to each withholding made.

2. For the collections: a voucher including the data provided by the regulations.

If the individual subject to withholding and/or collection would not receive the corresponding voucher, he should inform AFIP, within the 5 (five) administrative working days, as of the date said circumstance occurred, through the presentation of a note before the entity which according to the jurisdiction corresponds to his domicile.

6. NEGATIVE EXTERNALITIES OF THE WITHHOLDING AT THE SOURCE SYSTEM

Having described the objectives that led to the creation of the tax withholding at the source systems, one must now analyze the fraud incurred by those intervening, the latter being the main problema faced by the TAs.

The withholdings and collections are for the individual subject to the withholding a registered tax, which reduces the balance to be paid or, in its stead, generates a free availability balance in favor of the filer which may be used to pay other taxes, transferred to third parties, or request the treasury for its refund. Fraud then lies in the fictitious overvaluaton of these items.

Although there are different modalities for incurring in fraud, they may be combined in two main groups:

1.- Calculation in the sworn declaration by the taxpayer of nonexistent withholdings and/or collections (modality which may be easily detected by the TA).

2.- Calculation in the sworn declaration by the taxpayer of withholdings and/or collections declared by the withholding agents which exist in the tax registries, comply with all the formal aspects, but which were created to undertake and document fictitious transactions (complex modality, which is difficult to detect by the TA).

6.1. Operational problems

The Withholding Agent (hereinafter, WA), assumes the collection role and replaces the Fiscal Organization. To this end, he must comply with a series of formal and material requisites, aimed at the appropriate functioning of the “withholding at the source” system.

We must stop for an instant in the formal obligations of the WA, whether that of providing the vouchers of the tax applied to the Withheld Individual (hereainfter WI), or that of reporting with names the withholdings made.

Within the framework of compliance with the formal obligations of filing an informative sworn declaration, a series of inconsistencies are generated; namely:

1. The WAs do not file SR on withholdings: according to this assumption, the Administration is not aware of the amount withheld to the WI and when the latter carries out procedures, it will report the omitted transaction. The WI must provide copy of the withholding voucher in those procedures that may be objected due to lack of information from the WAs.

2. The WAs incorrectly report the codes or taxes corresponding to each system: within the regulatory standard, a code is established for each system with respect to each tax. A mistake in one of these codes, causes inconsistencies for the WI and also for the WA.

3. The WAs globally report the withholding vouchers: in this way they prevent appropriate knowledge of the transactions carried out between the WA and the WI for purposes of the corresponding controls. It is not possible to undertake crosschecks of withholding information returns with the vouchers provided by the WIs.

4. THe WIs report on the withholding vouchers in periods that differ from those of the WA: as indicated in the previous paragraph it is imposible to undertake information crosschecks, given the temporary dissociation existing between vouchers reported by the WAs and those declared by the WI for the same fiscal period.

5. The WIs report erroneous codes, taxes and dates: inability to undertake systemic crosschecks.

6. The WIs report the same voucher more than once: this situation generates a real decrease of the tax burden by the WI. With respect to systemic crosschecks, the latter become difficult, since the duplicity of withholding vouchers is not symmetric with respect to the totality of data; that is, although the vouchers are duplicated, some data is modified to avoid these crosschecks.

7. The WAs generate nonexistent credit notes to reduce the burden; as in the previous paragraph, it is a trick used by the WAs to avoid full deposit in the fiscal treasuries of the amounts withheld to its suppliers. Thus, they simulate transactions involving the return of goods, thereby generating tax credit notes that obviously reduce the tax burden.

7. CONTROL SCHEME OF THE WITHHOLDING AT THE SOURCE SYSTEM

It is worth recalling that the Argentine tax system is based on tax self-assessment by the taxpayer and the subsequent control by the TA.

In this respect, taxpayers resort to tricks and swindles to reduce what they must actually pay by way of taxes. These swindles are many times the result of weaknesses in the TA circuits, while many others they are “true Works of evasive engineering”, where they simulate a whole comercial chain involving several taxpayers and transactions in order to make it difficult for the TA to discover the maneuver.

Improvements in Information and Communication Technologies (ICTs) have resulted in ever more powerful and speefdy tools for detecting these frauds, but have also allowed evaders to have available lots of information about the TA.

It is appropriate to devote a paragraph to provide a specific example regarding this aspect. Prior to 2007, the TA carried out all controls and management through internal computerized systems, without allowing the taxpayer any opportunity to see the information existing in the data bases.

As of that year, there is a complete and complex change in the legal-tax relationship. The Tax Account System is created, whereby the TA performs all the controls and managerial actions that are part of its mission, but in addition, the taxpayer may access the same information and the same inquiries as the TA. This implied a change in several paradigms; among others, that of transparency of the information. As of that change, the taxpayers had access to “ex ante” and “on line” controls performed by the TA; hence, those who sought to evade the tax owed now had more information; in this case, beneficial for its purposes.

Given these situations, the TAs should not go back in their implementations to avoid frauds, but rather move forward and include more and greater controls which, once detected by the evaders should again be “updated” toward a higher evolution. It is, in sum, a permanent update.

In this regard and going back to the basis of the presentation, one should describe which were (and to some extent, are) the steps toward said “permanent update”.

In the withholding at the source system, as was described “ut supra”, the first point to be considered is to generate a “conflict” between the Withholding Agent and the individual subject to withholding, in such a way that if the latter has a document showing the tax applied, it is important to visualize the behavior of the Withholding Agent with respect to the part of “its” tax which the WA assumed.

If we were to follow a logical sequence, after a certain amount of time would have elapsed that would allow for creating awareness so that the Individuals subject to Withholding would control the Withholding Agents, the second step in this process would be to oblige the Individuals subject to Withholding to use the amounts that were retained based on the information shown in the TAs data bases, and which originates from the information of the Withholding Agent. Obviously, this process should allow claims from the individuals subject to withholding given the nonobservance of the rules by the Withholding Agents.

The third, and perhaps the last stage, would be the computerized systematization of the entire withholding process, where the Withholding Agent would enter a site in the TA to obtain the withholding certificate and automatically said certificate would generate the credit balanvce in the account of each Individual subject to Withholding.

These are the three steps undertaken by the TA and to which we will be devoting the following sections.

7.1. System for inquiring about withholdings

The first stage of this process for controlling Withholding Agents consists of rendering transparent the information to all those intervening. We had said that the State, for different reasons which we described, uses the withholding or collection at the source scheme and to this end, it designates a specific group of individuals who –in addition to intervening in the transactions carried out – will also take over the role of "collector on account of the State" and will subtract an amount of money from that which must be paid to its suppliers and which constitutes part of the tax owed by the latter.

Thus, we see a paying individual that withholds a part on behalf of another party (State) and a third party that sees a reduction in the amount received, on account of a certificate that represents a tax credit for the latter. The three (3) parties as of now may observe the materialization of the "withholding at the source" scheme through a computerized system. A system which shows –every taxpayer – the information filed by the Withholding Agent and which includes –or should include- the totality of withholdings made in a specific month, with a precise indication of the individual that has been subject to said tax.

In this first stage, the Individual subject to Withholding observes, reviews and reconciles the data visualized in the computerized system, but when filing and determining his own tax, he disregards what he has seen and only uses as basis the certificates which each Withholding Agent has been providing him throughout the fiscal period.

That is, although it could be considered that the operational issues described do not appear to be moderated or improves with the installation of a system as the one described, its implementation appears to be a crucial step throughout the process, since it begins to generate in each of the intervening parties the "culture" or "awareness" of revising and reconciling a computerized system which includes the registries of all the individuals intervening in the comercial transaction.

This first stage –it could be said – is the most neutral for the TA, since one must invest resources for developing the computerized tolos, without any direct impacto n the operations of the other two intervening parties. The Withholding Agent continues to file the sworn declaration every month, indicating the details of each of the transactions subject to withholding, while the Individual subject to Withholding has the slight (?) advantage of seeing what they reported with respect to his commercial transactions.

7.2. System for calculating withholdings in sworn declarations

The second aspect constitutes a relaunching of the system described in the previous paragraph because it maintains all the informative and operational logic, although with an important aggregate: at this time, the Individual subject to Withholding generates the balance in favor resulting from withholdings made, based on information he is visualizing –in a TA computreized system.

To generate such tax credit, the system allows him to make a series of adjustments and aggregates common to the operation of the withholding scheme. Thus, the taxpayer may calculate withholdings on taxable events whose claim includes the sworn declaration. Thus, a raw material purchasing transaction on day 30 of one month with delivery of the goods on that same day and with the payment date anticipated for the first day of the following month, will be a taxable event of the previous month, but the withholding –as a direct consequence of the payment made that month- will have a different application by the Withholding Agent, who is not obliged to declare it the previous month, but rather in the month when the payment was made.

Such transaction might not be registered in the system until the middle of the following month, regardless of the fact that to the Individual subject to Withholding it is considered as tax entered in the month when the sale of the goods is declared (previous fiscal period).

In the case described, the Individual subject to Withholding must manually register the withholding voucher or change the fiscal period of the already existing one so that, added to the other correctly applied vouchers, the system may generate the balance in his favor.

In sum, it is an application which includes all the withholding vouchers provided by each Withholding Agent with the information from the Withholding returns filed every month. This application allows all Individuals subject to Withholding to consult all the withholding vouchers that all the Withholding Agents have reported to the TA.

Finally, the Individuals subject to Withholding reconcile the information which they visualize in the system with their own records, update the data or include the missing ones and generate a voucher that will represent the credit they will have available to be applied to the sworn declaration of each of the taxes involved.

The value added of this stage of implementation lies in that the control actions must be aimed at the vouchers modified by the Individuals subject to Withholding and mainly at the vouchers which they have entered manually. The TA thus has an important operational data base –in principle- suspicious, and with respect to which it knows in advance that no Withholding Agent has reported it and much less, entered the amount owed.

7.3. Electronic Withholdings Integrated System

The TA, even with the tools described in the previous paragraphs, cannot avoid fraud in the withholding at the source system.

There is a new alternative for evading, not only the taxes, but the TA controls. It consists of creating a false Withholding Agent in those systems wherein the individuals are not nominated, but rather they arise from carrying out taxable events defined in the tax regulation.

Although it does not actually exist, the Withholding Agent exists in the tax registries. Through the inclusion of indigents in the board of directors, companies are created which comply with all formal aspects for their operation and to carry out and document fictitious transactions that will only serve so that other individuals (users) may benefit from formally valid withholding certificates, which have correctly filed in time and form, but which obviously have not entered the allegedly withheld amounts. Notwithstanding the non-entry, the sole information and filing of the sworn declaration originates the right of the Individuals subject to Withholdings –if they have the corresponding certificate- to register said amount. In the trilogy described above, the non-entry of the withholdings is an issue to be solved between the TA and the Withholding Agent. As of now, this can be distorted and become an issue of the three intervening parties, when the TA shows that it is a matter of fictitious operations that have only been reflected in formality to validate the credit of the Individual subject to Withholding

To counteract these maneuvers one must resort to a third control tool, which consists of complementing with computerized tools the traditional scheme wherein the taxpayer declares his tax obligation and then the Treasury controls or verifies the correct assessment and payment of the tax. The new tools should allow for performing the “ex ante” controls.

In this sense, a system is defined for online reporting of withholdings and collections and generating the corresponding sworn declaration of the Withholding Agent and validating the data at the time they are sent. Thus, there is a change in the way Withholding Agents submit the information to the TA, by incorporating validations prior to sending them, thereby invalidating the presentation or which, as appropriate, may generate early alerts for the TA’s control actions.

As of this first control, the operation is linked to the previously described procedure where all individuals subject to withholdings may review the reported registries.

In addition to the instruments of electronic withholdings, one must include the obligatory use of the electronic invoice for all taxpayer transactions, by contributing a series of control elements that are positive for the treasury-taxpayer relationship.

In the case of collections, where the “quantum” thereof is added to the amount of the transaction to be collected, the electronic invoice generated through the TA systems constitutes the collection certificate, thereby interacting with the electronic withholdings

system and generating the described automatic operation. In an extreme automatic operation (theoretical exercise according to the rules in force), someone who has carried out a commercial transaction subject to the collection regime, for which he received an electronic invoice, may immediately see in his account a balance in his favor, as a result of that additional amount paid to the Collection Agent. Obviously, for this to happen, the issuance of the electronic invoice with the additional collection, must likewise constitute the Collection Agent's sworn declaration.

8. CONCLUSION

The control of the Withholding Agents is one of the most important challenges of the TAs. This is so, because it is the State itself which assigns them that role and because it places in their hands one of the most important elements for its operation: tax collection.

After having gone over the importance for the State of the creation of the withholding at the source systems and analyzed the experience in the operation of the system, special attention should be given to the individuals who act as such, either because they have been designated by the TA, or because their commercial operations have involved them in the indicated taxable events to apply the withholding at the source scheme.

On the other hand, even though placing the emphasis on the individuals that act as Withholding Agents, we saw that the computerized tools thought, designed and implemented for controlling them, although they may have served to reduce the occurrence of fraud, they have not been able to eliminate harmful events.

There clearly appears the path that should be followed by the TAs to avoid fraud in the withholding at the source system and that is the path of functional and computerized integration of all the transactions of individuals who must act as Withholding Agents, with special emphasis on closing the life cycle of a withholding.

This implies that every withholding must be registered since the beginning in a TA system, its collection should be followed at all administrative and judicial instances, the correct registry and declaration of the transaction which originated it should be ensured and finally, its calculation in the sworn declaration of the Individual subject to Withholding should be traced.

Only by complying with all of the steps described can one ensure a correct and complete control of the withholding at the source system.

Topic 1.4

EMPLOYER COMPLIANCE WITH PAYROLL REQUIREMENTS: THE CANADIAN APPROACH AND PRACTICES

Michael Snaauw
Assistant Commissioner
Revenue Agency
(Canada)

Contents: 1. Introduction. 2. Key program elements. 3. Program characteristics. 4. Program design. 5. Challenges. 6. Enhancements. 7. Future plans. 8. Conclusion.

1. INTRODUCTION

Canada Revenue Agency

The Canada Revenue Agency (CRA) administers tax laws, benefits, and other related programs throughout the country for the Government of Canada, and the majority of its ten provinces and three territories.

Employers and businesses play an important role in Canada's tax system by withholding taxes and other deductions at source. As Canada's national revenue agency, the CRA collected $255 billion through source deductions remitted by 1.7 million employers in the 2014-2015 fiscal year alone. Personal income tax revenue deducted at source represents over 50% of the yearly total amount collected by the CRA.

In Canada, it is not uncommon for employers to offer additional types of compensation over and above wages that affect employees' earnings. To ensure tax compliance in such situations in a self-assessment system, the CRA maintains programs that provide the necessary support to employers, businesses, and taxpayers to meet their tax obligations.

This paper explains the role of the Employer Compliance Audit (ECA) program in achieving the CRA's mission of attaining compliance, particularly when taxable benefits are provided to employees.

Employer Compliance Audit

The CRA has administered the ECA program for over 30 years to promote and enforce compliance under the *Income Tax Act*, the *Excise Tax Act*, the *Canada Pension Plan*,

the *Employment Insurance Act*, and respective regulations.

The ECA program is mandated to maintain the integrity of Canada's tax system with respect to employers' obligations. Its primary focus is on the withholding and remitting of payroll-related amounts for taxable benefits and on ensuring the proper characterization of workers. This is achieved through a combination of responsible enforcement and education.

The program performs books and records reviews to ensure compliance and to establish that all employers uniformly and consistently apply tax laws. The ECA program also assists in creating a level-playing field amongst employers by ensuring that those who do not comply with tax laws are not afforded a competitive advantage over those who are compliant.

The ECA program forms part of the CRA's employer compliance continuum with a focus on payroll. In the domain of compliance work, there is a gradually increasing level of intervention depending on the non-compliance detected, the level of risk identified as a result of that non-compliance, and employers' compliance attitude. Less intensive actions include telephone calls, letters, meetings with employers and education. The ECA program is the most intensive part of the employer compliance continuum, providing a detailed, in-depth examination of employers' books and records.

There are two paths that can be undertaken when enforcing compliance: an audit or education. Although there is an element of education in an audit, the ECA program may establish that specific files are best suited for education if there is an industry-wide discrepancy identified.

2. KEY PROGRAM ELEMENTS

Target audience

The potential ECA target audience consists of individuals, corporations, testamentary and *inter vivos* trusts, and financial institutions. The audience includes what is commonly referred to as the MUSH sector: municipalities, utilities, schools, and hospitals. Employer Compliance (EC) auditors also audit provincial and federal government departments and agencies, as well as crown corporations, charities and unions. Only employers who provide taxable benefits to their employees or whose employer-employee relationships require further examination can be subject to an ECA.

Taxable benefits

In addition to providing employees with remuneration in the form of monetary compensation, employers sometimes also provide benefits or allowances to their employees such as: automobiles, gifts and awards, group life insurance, security options, etc. When such benefits are provided to employees, it is the employer's responsibility to establish if the benefit is taxable, determine the value of the benefit, calculate, and remit the payroll deductions on this amount, and file an information

return.

The ECA program focuses on employers who provide these taxable benefits, but do not include the value in their employees' income. When taxable benefits are provided, and their value is not included in an employee's pay, the EC auditor may raise assessments on the employer for amounts not deducted or remitted for required Canada Pension Plan contributions (CPP – the national pension plan) and Employment Insurance premiums (EI – the national unemployment insurance plan). The employer is also required to file amended information returns for each of the affected employees to include the value of the taxable benefit. When an increase to employees' income results from including the taxable benefit on their information return, assessments are raised on the affected employees.

Employer-Employee relationship

An EC auditor is also responsible to review the status of workers to determine whether employers properly characterize their workers and make the required deductions at source.

In general terms, a "worker" is categorized as either an employee or a self-employed person (a contractor). The tax treatment for these two types of workers is different, and there are incentives for both workers and employers to classify the worker as a self-employed individual. For example, if a worker is classified as self-employed, the employer is excluded from remitting the employer portion of CPP contributions and EI premiums, and the worker from contributing these deductions at source.

In instances when employees are incorrectly treated as self-employed contractors or incorporated employees, auditors gather information on the employment contract and refer it to an area of the CRA that makes legally binding determinations of the classification of the worker. Once the determination is made, the EC auditor applies the correct tax treatment.

3. PROGRAM CHARACTERISTICS

Structure

The delivery of the ECA program is a shared responsibility between Headquarters' (HQ) and the local offices across Canada.

HQ distributes the funding and the yearly program accountabilities to the local offices. It also provides technical support, evaluation of program quality and efficiency, develops and coordinates the delivery of national and/or local projects related to taxable benefits, and develops strategies to detect and correct areas of non-compliance. HQ is also responsible for establishing specific educational and compliance strategies, providing a national approach to address ambiguous employer-employee relationships and ensuring unreported income and taxable benefits are assessed in the same fashion in

all the local offices. The local offices are responsible to deliver the program, and develop and distribute the workload.

Once the files are assigned to the local ECA team, the EC auditors typically work on their assigned cases independently, but there are occasions when more than one local office is involved in gathering information. For example, if the books and records are held in a different geographic location than an employer's premises, the local office conducting the audit works with the office closest to the books and records to collect the required information.

Size

The ECA program is relatively small considering its impact. Historically, the program completes approximately 750 to 800 audits per year across Canada on 1.7 million active employers.

The program's total salary expenditure is approximately $7.2 million. At HQ there are five full-time employees dedicated to the program, along with a manager. In the local offices there is a total of 113 full-time employees, including the auditors and managers.

Impact

The program's impact is significant with a return on investment in the 2014-2015 fiscal year of 13:1, averaging over $129,000 per audit. The 744 EC audits performed in 2014-2015, resulted in changes to over 18,000 employees' income, with a fiscal impact of over $96 million.

The program achievements are significant when considering the fiscal impact resulting from relatively few audits.

4. PROGRAM DESIGN

Audit process

The ECA program utilizes a program design that includes identifying, planning, conducting, and reviewing the workload.

The local offices identify files with potential non-compliance using various tools and methodologies, such as referrals and analysis of internal CRA data. A file can be included in a workload if the full scope of an audit can be completed effectively and efficiently.

For example, large employers may have a non-compliance issue that affects a high number of employees, each with a low dollar adjustment. The reasonable cost associated with identifying these adjustments by the auditor, processing the

reassessments, and the potential impact to the CRA, can make an audit approach an unreasonable way to address this type of non-compliance issue. In such a situation, an educational approach is a better alternative.

To ensure CRA resources are best used and the most at-risk files are selected, three elements for each file are identified to consider it appropriate for an ECA. An element is generally identified when there is a discrepancy between what is reported by an employer and what is typically found for that industry sector. For example, if a particular industry sector generally provides automobile benefits, parking, and stock options, an employer in this industry that does not appear to exhibit these same characteristics can be selected for an ECA.

Once files are identified for audit they are assigned to an EC auditor at the local office.

The auditor's primary role is to identify non-compliance and enforce compliance.

Through the course of the audit, however, the auditor also educates the employer on their obligations and reporting requirements under tax laws.

The auditor conducts a thorough examination of the employers' books and records, ensuring employment income and taxable benefits are accurately reported and source deductions are withheld and remitted. Generally, audits are restricted to the two most recent calendar years for which corporate tax returns are filed.

If taxable benefits are identified, and their value is not included the employees' income, the EC auditor raises assessments on the employer for amounts not deducted or remitted for CPP and EI. The employer subsequently amends the impacted employees' information returns to include the value of the taxable benefit.

The CRA completes a cursory review of the completed audits to determine whether the program objectives were met and to assess the success of the audit.

An audit is deemed successful if the criteria identified in the planning phase are fully or partially met, or if additional areas of non-compliance are discovered. This assists in the future planning of ECA files. If the elements are met but the audit resulted in no change, the CRA will revise its approach when establishing future strategies and file selection methodologies.

The program's success is determined through performance measurement criteria, including resources utilized, number of files completed, and fiscal impact resulting from the audits.

Education approach

While the primary purpose of the ECA program is to achieve compliance, enforcement actions can result in an education approach, rather than an audit.

In instances when there is a high level of non-compliance in an industry, it is often preferable to educate employers rather than conduct audits. This approach encourages long-term voluntary compliance.

When an education approach is taken for a specific industry sector, an education strategy is developed which can include campaigns, webinars, and third-party initiatives.

A campaign consists of educational letters on a particular area of non-compliance, publications in impacted organizations' newsletters, and direct consultations with industry associations' executive teams. After a campaign, follow-up audits can be conducted to establish the effectiveness of the approach, to determine whether there is increased compliance in the sector, and to provide additional guidance to employers.

Although assessments are not typically raised from a follow-up audit, the results may influence future policy changes, enhance outreach efforts, provide data for additional educational campaigns, and/or direct future enforcement activities.

Webinars (web conferencing) are another tool used to educate employers on their tax obligations. Webinars provide an effective forum to reach large numbers of employers across the country. Webinars target and engage specific groups and educates them on the taxability of the benefits they provide their employees, as well as on what to expect during the course of an ECA.

Officials from the CRA also participate in a number of committees and present to various external stakeholders, including those with payroll service providers. These interactions provide yet another forum where information on the taxability of employer provided benefits is shared.

5. CHALLENGES

Program viability

The ECA program is one of the CRA's smallest and most specialized audit activities. It requires special management attention to ensure it remains viable as an effective, sustainable, and evolving program.

The program has a small number of experts compared to most other audit groups in the CRA. Since these experts are separated by thousands of kilometres, the CRA must take specific steps to ensure the program and its staff are supported, and employers who are audited receive consistent, excellent service.

Virtual management, specialist networks, and a national strategic focus are some of the measures that have proven successful in sustaining a common goal.

Impact on Employees

Canada's tax system requires taxpayers to file annual income tax returns, where they report income and deductions, as well as claim tax credits. To validate the information on income tax returns, employers provide yearly reports to the CRA that include the wages and other income of every employee. Employers' data is compared by the CRA to the income tax return of employees to ensure the information is correctly recorded.

When an ECA determines an employer incorrectly reported taxable income for some or all of its employees, each of their tax accounts must be corrected. In some situations, thousands of employees are impacted. The employees are then personally responsible to the CRA for paying any resulting new tax debts. If they disagree with the tax assessment, employees must apply for individual recourse to the CRA.

Corrections to employees' tax accounts can result in severe financial consequences due to the amount of previously undeclared benefit received from their employer over the period of the audit. In certain situations, with the agreement of all employees affected, the CRA works with the employer to address the tax consequence by accepting a bulk payment from the employer. The payment is subsequently allocated to the employees' tax accounts.

It is highly unusual in Canada's tax regime for audits of a single entity to generate immediate consequences for many others without their advance knowledge. ECA requires careful management to ensure the audits are not overly disruptive to employers, employees or the tax administration.

6. ENHANCEMENTS

Renewal

In 2013, the CRA completed a renewal project to review the program and develop a revised delivery model. As a result of the renewal, a national compliance strategy and educational audits were introduced.

The national compliance strategy established a model of communication for HQ to receive ongoing feedback from the local offices on emerging trends identified in industry sectors. The continuous communication has resulted in strategic advancements in combating non-compliance through education.

The results of the renewal emphasized the importance of consistently administering legislative requirements while also proactively educating employers before issues arise.

Best practices

The ECA program has adopted two distinct best practices: national specialist networking and segregation of duties.

The small size of the ECA program allows the staff from each office to stay connected and maintain an ongoing dialogue between HQ and the local offices. Employers across Canada treat tax situations—specifically taxable benefits—differently. Consequently, it is essential for representatives from the ECA program to communicate and share their observations. The size of the program allows the different offices to share information and best practices rapidly. It also permits auditors to receive the attention required when seeking support from HQ.

Another feature of the program is its segregation of duties. No single employee is involved with more than one aspect of the treatment of a file. The steps taken with a file are broken down into four steps: file identification, file assignment, file completion and file approval.

To adhere to the segregation of duties, the ECA program implemented both system-based restrictions, as well as procedural-based assurances. The system-based restrictions log the steps taken on a file and ensure that an employee does not perform more than one step in the process. Procedural-based assurances identify who will perform specific functions in the process, and how the completion of a file will take place. Together, the system and procedural limitations ensure the integrity of the ECA process is maintained.

7. FUTURE PLANS

Research and data mining

The ECA program is continuously exploring ways to ensure the most at-risk files are selected for completion. Two of the methodologies used are research and data mining.

Research includes using sources such as the internet, public databases, newspapers and other publications, and internal and external leads to further determine files with the highest risk of non-compliance.

The CRA holds a large volume of information in its systems that can be used to identify the most at-risk files for selection. The ECA program recently initiated the first steps to explore alternative information to assist in this file selection. Traditionally, only limited information was evaluated to determine which files to select, but the use of enhanced research and the mining of CRA data is expected to produce a better file selection methodology. The ECA program is also examining the possibility of gathering information and performing research that takes advantage of data that is held by other government departments.

Enhanced workload management reporting and employer feedback

To enhance the development of future workloads, history is used as a determining factor. The ECA program has started enhanced data collection on its specific activities.

Aside from capturing the results of an audit, data collection on specific industries and sectors will also be taken into consideration.

At the outset of a program year, the local offices identify a workload plan that is aligned with the objectives established by HQ. The workload plan details the files that will be worked throughout the year.

The ECA program is implementing a feedback mechanism whereby the local offices will transmit the audit results to HQ. HQ will use this data to prepare the following year's objectives. This ongoing feedback loop should ensure that areas of non-compliance are determined and that the most at-risk files are selected for audit.

8. CONCLUSION

Despite its small size and challenges, the ECA program has a substantial return on investment. With recent strides taken by the ECA program, and initiatives that are underway, the CRA is ensuring that it evolves to continuously identify non-compliance across Canada.

Employers continuously find new and innovative ways to attract, retain and reward employees. What might have been a cash bonus in the past for an employee's good performance may now be a gift card or a computer tablet. Regardless of the form of the reward, it is a taxable benefit that must be reported in an employee's income.

Although the CRA will continue its efforts to educate employers on their tax obligations and the taxability of employer provided benefits, there will always remain a level of non-compliance that ECA can address and resolve. As such, the ECA program will continue to adapt and improve its efforts to address the evolving challenges associated with employer compliance.

Topic 2.1

FISCAL CONTROL OF DIGITAL ECONOMY

Jorge Rachid
Secretary
Federal Revenues
(Brazil)

Contents: 1. Key features of the digital economy. 2. Taxes involved. 3. More usual businesses in the digital economy. 4. Evolution. 5. Some of the sectors that benefited from technological innovation. 6. Users data and value aggregation. 7. Tax connection and revenues assignment. 8. Revenue assignment. 9. Characterization of services provided on the internet. 10. Payments to non-residents. 11. Difficulties in the characterization. 12. Payment services. 13. Confusion in the client identification. 14 information and communication technology structures in levels. 15. Challenges in controlling digital economy companies. 16. VAT. 17. B2b services trade: 18 b2c services trade. 19. Conclusion.

Business models of the digital economy

1. KEY FEATURES OF THE DIGITAL ECONOMY

BEPS Action Plan already exposed that “the spread of the digital economy also poses challenges for international taxation. The digital economy is characterized by an unparalleled reliance on intangible assets, massive use of data (notably personal data), widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs. This raises key issues about how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterization of income for tax purposes.”

2. TAXES INVOLVED

According to the tax policy, besides the direct taxes on companies income, the two more usual types of excise taxes are:

a) Goods and services tax, known as value-added tax (VAT), sales tax, and goods and services general tax.
b) Taxes on specific goods and services, consisting of special taxes (excise tax), customs duties and taxes on specific services (as insurance premiums and financial services).

3. MORE USUAL BUSINESSES IN THE DIGITAL ECONOMY

a) Goods E-commerce

The Business-to-consumer (B2C) model of commerce is among the earliest forms of electronic commerce. The sale is done to individuals that purchases the goods without professional objectives.

The commercialized goods can be tangible (such as music CD) or intangible (received by the client in an electronic format).

The digitalization of information allows that many products, such as texts, audios, images and others goods and services can be remotely delivered to clients in any part of the world.

Due to the disintermediation, B2C businesses strongly invest in advertising and customer service, as well as in logistics. The cost to enter into the market is also substantially reduced by the fact that maintaining a website is less burdensome than developing a physical sales chain. For the consumer, the B2C commerce reduces the time and cost of researching goods and services.

App Stores

The success of smartphones and tablets took off the application stores industry, or App Stores, platform used to digitally distributes software. These stores are usually like retail central platforms that are accessed through the users' device, and in which the consumer realizes searches, downloads and installs apps, upon payment or for free.

Some apps are only usable for consumers with specific devices. Free apps can be sustained by advertisements published in many ways. There are apps that utilize the freemium model, that is, the apps are free and the user, in case of wishing other functions, can pay for a premium version.

C) Online advertising

The online advertising uses the Internet to target and send marketing messages to consumers. The online advertising brings numerous advantages, such as the segmentation of potential consumers and the possibility of monitoring the preferences for online ads, tracking how users navigate in the Internet.

This kind of advertising is done in many ways; the most common is with the massive release of ads, which the advertisers are paying for being shown, associated with the user behavior, like when he pays to appear in online researches.

Cloud computing

Cloud computing is a service standardized, configurable, on demand, with online computing, that can includes data computing, storage, software and management, using physical and virtual resources. The users can, typically, use many types of devices to access the cloud computing.

The most commons models of cloud computing are called: IasS (Infrastructure-as-a-Service), PaaS (Platform-as-a-Service, SaaS (Software-as-a-Service), CaaS (Content-as-a-Service) and DaaS (Data-as-a-Service).

Payment services

Payments in the e-commerce involve a certain amount of information, such as bank account and credit cards numbers, what requires some confidence, something difficult to happen in a C2C transaction without having an intermediary ensuring the operation.

Online payment services allow a secure way to make payments without requiring personal financial information of the parts involved in the transaction.

The payment service acts as an intermediary, typically using a Software-as-a-Service model, between the buyer and the seller, accepting a variety of payment methods, processing those payments and depositing the funds on the seller's account.
f) Participative networked platforms

A participative-networked platform is an intermediary that enables users to cooperate and contribute to the development and expansion, with the possibility of classifying goods and services, making comments on and distributing user created contents.

A range of platforms was already created, such as text-based collaborations, like the wikis and blogs, with the aggregation of contents through social medias, virtual worlds and other examples. The UCC (User Created Content) is usually made available without expecting any profit.

The most common practice is to involve people through social networks, but this model is used in other areas as computer games, toys projects and fashion, etc.

The collaborative output is still not very widespread to the development of products, but some companies already do it by social networks.

4. EVOLUTION

In the beginning of the digital era, traditional companies (*brick-and-mortar*) adapted their business passing to market products that were traditionally physical in a digital way, as example of the selling of physical books.

In the second stage, the retailers started to commercialize digital products and services, such as music, movies, games and services based on data processing.

The advertising started from the traditional models of ads and became more sophisticated as far as the technology developed.

The businesses of the digital economy started to develop innovative models supported by new technologies, obtaining flexibility and efficiency, operating with low costs and expanding to global markets.

As far as the innovation and the transformations of legislation make viable and less burdensome the transfer of business and intangibles functions to others jurisdictions, the interest transfer to low-tax countries is increased, intensifying the BEPS phenomenon.

5. SOME OF THE SECTORS THAT BENEFITED FROM TECHNOLOGICAL INNOVATION:

a) Retail: the new technologies allow the consumers to make requests from anywhere in the world. The companies started to collect substantial data of their clients. The new technologies also allowed the development and management of the logistic needed for business.

b) Transport and Logistics: new technologies allow to track freights and vehicles, which made the process of their clients more easy, including those that operate in the just in time system. The telemetry allows to manage the transport network and to program the maintenance of the fleet. The information collected about the fleet allow its use in a data joint with commercial value.

c) Financial services: banks, insurance companies and other financial services broadened their services, including allowing their clients to manage their finances. A larger number of data allows companies to offer more customized services to their clients.

d) Manufacturing and Agriculture: the digital economy increased the project and the development of products, as well as the possibility of monitoring the output in manufactures and robot control, which give precision to the production process. The products started to be more intensive in knowledge. In farms, the new systems can control the production in plantation and of animals, as well as monitoring the soil and other production factors.

e) Education: the digital economy allowed expanding the quantity of universities, offering tutor services and education from distance. In addition, the interaction through video conference reduces the personal contact, which leverages the brands and operations in a global level.

f) Healthcare: the technology is allowing the remote diagnosis and an increase on the efficiency of patients follow-up by electronic records. It also opened the market for the trading of drugs and others treatments.

g) Communication Enterprises (broadcasting and media): TV broadcasting was significantly modified in the digital economy, opening new ways to content allocation and expanding the user participation as a content producer. It also allows the media to collect data about the users habit and their consumption preferences, allowing the targeted advertising.

6. USERS DATA AND VALUE AGGREGATION

Users provide to the digital economy companies a huge quantity of data, usually personal and that are used in different ways to customize the experience of the user and to generate productivity and scale gain.

Personal data can be collected directly from the users, when they register in certain online services; can be observed, by tracking their activities on the Internet and their location; or can be inferred based on their online activities.

As far as more and more data is collected, it is possible to provide a more customized browsing for the users or to offer products associated with their profiles.

Assign value to a business by value aggregation is not an easy task, but this value is more evident when big companies acquire start-ups that were born on the digital economy, or in a fusion process, where companies values are more defined.

The ability of connecting any device or object with a network enabled the development of the “Internet of Things” concept. The term refers to a series of same importance components, including machine-to-machine communication, cloud computing, big data analysis, sensors and actuators that, combined, enable the machine learning and the remote control.

6.1. Content

This concept gained importance in the end of 90s, when content production, consume and indexation emerged to drive the growth of digital economy. In this period, it were launched the first content portals and research machines that act as internet gateways. Currently, many digital economy actors are content providers.

The content definition is larger and includes copyrights produced by professionals and content without copyrights produced by users, such as comments done in forums, pictures, videos, etc. The flow of content is important to attract new consumers or new audience and to cause interactions between users. Content became a leading force to the internet advertising industry, in order to attract audience and monetizing the advertising together with the advertisers.

Wikipedia and Youtube are examples that an entirely experience can be created with content produced by individual users. With social medias, the links and interactions between users appear as an essential factor to attract each time more audience. Even the advertising depends each time more of the content acquired, becoming one of the marketing pillars. Other techniques as the cookies, targeting, retargeting and collaborative filters are essential to network marketing.

The content can be owned, that is, distributed by the brand or channel; paid content, distributed by other media upon payment done by the brand, and acquired content, intentionally created by users and shared without direct payment by the brand, such as in comments about products traded online, social medias, etc.

6.2. Mobility

Mobility of intangibles
The development and exploitation of intangibles are essential for the digital economy. The growth of businesses is directly associated with the growth of intangibles dependence. The rights over those intangibles can be easily assigned and transferred among associated companies.

Mobility of users and consumers
Advances in technology allow users and consumers to realize business anywhere in the world, as far as they move on the planet.

This mobility creates difficulties to establish a connection between the transactions and the individual, what can be aggravated by the possibility of using virtual personal networks to, whether intentionally or not, disguise the location in which the sale took place.

Mobility of business functions
Companies are able to manage global operations on an integrated basis from a central location, that can be geographically transferred to next to where the operations happen or next to their consumers or suppliers.

The remote access to markets was also extremely facilitated, providing goods and services without any physical presence or with minimal presence.

The technological advances allow a daily operation of the business with minimal personnel, phenomenon described as “scale without mass”.

The central management combined with maintaining a flexibility on the location of the business functions enabled companies to spread assets and functions in multiple countries.

7. TAX CONNECTION AND REVENUES ASSIGNMENT

7.1. Permanent establishments

The rules of the UN and OECD Model Convention establish that the profits of a company are exclusively taxed in the country of residence, unless the company conducts business in other state through a permanent establishment (PE). In this last case, the source country can only tax profits assigned to this PE. In this manner, the PE concept is used to determine whether a contracting state can exercise its taxing rights in the profits of a company with non-resident taxpayers.

Special rules, however, are applicable to certain income categories, such as interests, royalties, dividends and capital gains.

The PE concept effectively acts as a limit, measuring the economic presence level of a foreign company at a certain state through an objective criterion, determining the circumstances in which the foreign company can be considered sufficiently integrated with the economy of the state to justify the taxation.

The results of Action 7 (Prevent the Artificial Avoidance of PE Status) bring changes concerning exceptions to the PE concept, submitting all the activities that can be merely ancillary or preparatory, in order to avoid abuses, as it was suggested by the Task Force in Digital Economy. The Action also hampers the conditions for a legal arrangement to be effectively considered a commission contract and, therefore, be considered an independent agent of the non-resident company and do not configure a PE in the source country. Moreover, establishes harder rules to avoid the fragmentation of activities to escape from a PE concept and brings new clarifications, in Comments, regarding arrangements that lead to artificial partition of contracts in order to elude the temporal test that defines a PE.

Although it was posed as an alternative, it was not possible to define what would be a digital economic presence in the market country and how this definition would be applied to establish the nexus and the form of taxation in the countries of residence and of source (market).

8. REVENUE ASSIGNMENT

Approaches that can be considered to the taxation of services in the digital economy:

a) withholding income tax in the source (IRRF) for digital transactions: imposition of IRRF in payments to non-residents, done by residents and by permanent establishments located in the market country. This source can be imposed in an isolated way, in crude basis, for certain payments or, alternatively, as a primary mechanism of collection and as a tool to support the characterization of a new nexus. The withholding in the source depends, in many cases, on intermediaries and these

agents should have enough information about the transaction to know when to apply the withholding,

b) presumption of PE profit: the assessment by presumed profit can be used to avoid complicated calculations and inspections of the operation profit when large part (or all) of the expenditures are incurred abroad. One possibility would be to consider the equivalent taxation to the activity that has physical presence, when a non-resident operates a business in the market country, to determine the liquid presumption, applying a certain percentage to deductible expenditures. Other approach to establish the liquid presumption would be stratify the companies by sector and to establish profit percentages for each industry. Surely, some multinationals could feel impaired with the definition of high presumptions of profits. The solution would be to allow this presumption to be contested by the company, when it demonstrates that the profits are below of the margin established.

c) fractional apportionment: divides the company profit as a whole in relation to the digital presence, based on a pre-determined formula or on variable factors of allocation, depending on the case. This approach is significantly different from the method of profit allocation to permanent establishments already used by many OECD countries. There is an additional difficulty in defining what is digital presence.

9. CHARACTERIZATION OF SERVICES PROVIDED ON THE INTERNET

Cloud computing

The new business models raise questions about how to characterize certain transactions and payments, in the light of domestic legislations and international tax treaties.

For example, cloud-computing services are not yet a part of the Comments to the OECD Model Convention. In terms of tax treaties, doubts can appear over the characterization of these services as royalties (certain treaties consider as royalties the payments done for the rent of scientific, industrial and commercial equipment), such as the remuneration for technical services (some treaties consider in this way), or as companies profit (Art. 7).

More specifically, it can be questioned if transactions of the type “infrastructure-as-a-service” should be treated as services (and, so, the payments would be suitable for Art.7) or as rent of space, by third persons, in the provider of cloud services (for treaties that also characterize as royalties the payments for the rent of scientific, industrial and commercial equipment).

Exists the possibility of conflicts between the Contracting States over the type of income characterization.

3D printings

3D printings provided by non-residents can also raise questions about payments characterization: can be considered as royalties, business profit (Art. 7) or remuneration for technical services.

Exists the possibility of conflicts between the Contracting States over the type of income characterization.

ISPs and OTTs

As the internet becomes a global phenomenon, the network of web components providers, the intermediary infrastructures and the Internet Services Providers (ISP), that operate the telecommunication infrastructure of networks forming the internet, became essential to the digital economy.

The ISP power was, originally, to provide access to the network, but it was not restricted to it.

As their businesses were not leveraged, ISPs started to have problems in maintaining their status as the only entry point for the final user, having to dispute space with companies that provide content and services directly to the internet users. These providers, usually known as Over-the-Top (OTT), started to deliver services to the users in a more responsive way. Examples of OTTs: Youtube and Netflix.

In the beginning of this process, ISPs were the only privileged entry points to final users, with high profit margins. Now, they operate in highly competitive markets, suffer extent regulations and are essentially locals, even if some of them acts in many countries.

In contraposition, the OTTs started to offer a differentiated experience to the user, they globally act and are not limited by the network extension, in contrast to the ISPs. They may be not subjected to taxation in the market countries (source), what enables them to compete in conditions that are more competitive.

10. PAYMENTS TO NON-RESIDENTS

10.1. Revenues

The way companies turn value into revenues is variable. Here are some of these ways:

a) Advertising-based revenues: one version of this model is the offering of free or discounted digital content for the users in exchange for them visualizing paid advertisements. Another version distributes the advertisement depending on the location of the user and other factors. A third type is through social media websites that

build up a community before monetizing their audience according to the possibilities of advertisements.

b) Rent or purchase of digital content: users pay the download of items, such as books, movies, music, games, apps, etc.

c) Selling of goods, including virtual items: it is sometimes confused with the first category. In this model, online retailers sell tangible goods, but they can also commercialize games, for example, offering the user a free or discounted product and the possibility of buying versions that are more complete.

d) Subscription-based revenues: include annual payments modalities for premium delivery with online sellers, monthly payments for digital content, such as movies, books, music, video-streaming, anti-virus software, data storage, consumer assistance services for operating systems and payments to access Internet.

e) Selling of services: this category is confused with the previous one, but includes traditional services that can be delivered online, such as legal, financial or consultancy services, travel agencies, etc. It also includes a large quantity of B2B services linked to companies that provide access to the Internet and act as intermediaries (web hosting, domain registration, platform access, etc.)

f) Licensing content and technology: it is confused with the two previous categories, but it includes access to specialized online content, such as publications and journals, algorithms, software, cloud-based operational services or systems that use artificial intelligence.

g) Selling of user data and customized market research: for data brokers, internet service providers, data analytics firms, including data obtained from non-personal sources.

h) Hidden fees or loss leaders: in integrated businesses where profits and losses can be attributable to online operations, but because of the business nature, subsidies can cross with physical operations that make it difficult to separate and identify what would be an online revenue.

11. DIFFICULTIES IN THE CHARACTERIZATION

The administrative difficulties of the digital economy can be resumed in the following way:

a) identifying the seller: in the market country, it may not be expected the registration or any type of identification when non-resident companies remotely sell to residents. Difficulties in this identification are linked with privacy and financial regulation issues.

b) identifying consumers: there are some means to identify consumers, such as through addresses that are recorded in delivery services, tracking of the IP used by the consumer/user, or credit card data. It is worth remembering that these data can be weakened to impede the identification.

c) determining the activities extension: can be extremely hard to determine the total sales of a foreign company in the market country. This information can be obtained, in some cases, through consumers and intermediaries that promote the payment of these sales.

d) exchange of information with foreign countries: not always is easy to define in which country the seller is resident, so the exchange of information between tax authorities can be required.

12. PAYMENT SERVICES

E-commerce payments involve a certain quantity of information, such as bank account and credit cards numbers, what is difficult to obtain in a C2C transaction due to the necessity of confidence.

Online payment services allow a secure way to make payments without requiring personal financial information of the parts involved in the transaction.
The payment service acts as an intermediary, usually using a Software-as-a-Service model, between the buyer and the seller, accepting various ways of payments, processing those payments and depositing the resources to the seller's account.

These services offer fraud protection by charging a fee for each completed transaction.

Other types of online payments include cash payment solutions, using a document with a bar code that resumes the operation; cyber-wallets, which are previously charged and can be used online, usually for small transactions where credit cards are uneconomical; and mobile payment solutions, which uses cellphones, tablets or the processing of cards connected with mobile devices.

13. CONFUSION IN THE CLIENT IDENTIFICATION

Sometimes the payment flow does not correspond to the contracted services flow, what can brings inconsistencies that will be more examined by tax administrations.

Assume that a multinational company hires a global consultancy company, in order to make each subsidiary of the consultancy company provide consultancy services to the multinational subsidiaries. Assume that it may be a master contract and many local service arrangements between the multinational and the consultancy company.

Also assume that the parent company pays to the consultancy company for all the services rendered in the different countries. If the payments flow does not correspond to

the contracted services flow in the local arrangements between both companies' subsidiaries, it may happen a confusion in the client identification.

14. INFORMATION AND COMMUNICATION TECHNOLOGY STRUCTURES IN LEVELS

A way to describe the information and communication technology sector is by focusing on the interactions in different levels of exchange, characterized by a mix of hardware and software.

There are six levels in which the various actors interact: infrastructure, software resources, accessibility for apps creation, apps, interfaces with users and users levels.

Each level has hardware, software and network connectivity resources. The resources can be founded in multiple levels, such as in data centers (infrastructure level), in virtual services located in the cloud and in the users' devices (computer, tablet, smartphone, etc). The business relations between different levels are always of clients and providers.

A company that operates a business in only one level is usually paid by a company of a superior level. For example, cloud computing operators provide accessibility, make payments to the infrastructure operators and are paid by apps developers. A company that operates in the last level derives payments directly from its interactions with users.

The multiple locations between clients and servers hamper the payments characterization and the obtainment of foreign information.

15. CHALLENGES IN CONTROLLING DIGITAL ECONOMY COMPANIES

BEPS phenomenon in the digital economy

Maximization of deductions in the market country.

If a non-resident company has a permanent establishment (PE) in the market country and the taxation of this country is high, one of the strategies applied is to maximize the deductions through payments to others companies of the group, royalties, interests or remuneration for technical or administrative assistance, etc.

Hybrid instruments are also used to create deductions in the market country, without having the expected counterpart included in the tax basis of the country of residence.

Tax removal or reduction in the intermediary country
Taxation in intermediary countries (between the source and residence countries) can be minimized with the use of countries' preferential regimes, by means of hybrid instruments or payments in excess to entities located in other countries (also intermediaries) with low or non-existent taxation.

The right to explore intangibles can be transferred for underestimated prices to companies located in countries with preferential regimes or with low-taxation. Considering the low-taxation, any revenue that comes from intangibles exploration or concession will be poorly taxed.

Tax removal or reduction in the parent company's country of residence
The same techniques applied to reduction or elimination of taxation in the market country can also be used in the parent company's country of residence. In this regard, goods and risks are contractually assigned to entities located in low-taxation countries, while a parent company starts to be poorly remunerated for its functions and risks, what will reduce its results.

If the country where the parent company is resident does not have CFC rules, the results deferral in foreign countries or even its non-taxation is facilitated, reaching the objective of minimizing the tributes in the parent company's country of residence.

BEPS Project

Within the BEPS Project, Actions 3, 7, 8, 9, 10 and 13 are, in particular, more relevant to the confrontation of the problem on digital economy.

Action 3

In what regards Action 3, the taxation rules for Controlled Foreign Corporation (CFC) are important to deal with the issue of the mobility of intangibles that are explored for the sale of goods and services through the internet. CFC rules are created to tax the profits that come from non-resident companies which partners are resident in the country where the rules are defined. It is a category of anti-avoidance rules or of extension of the tax basis, in order to tax partners which invest in mobile revenues that come from non-resident companies in cases that, in the absence of these rules, the revenue would be exempted for taxation, as in the case of territorial systems, or taxed only when a repatriation occurs (in universal basis taxation systems with deferral regime).

The measures proposed in Action 7 aim to prevent the PE concept avoidance, as it was defined in Article 5 of the Model Convention. In respect to this Action, measures will be proposed to fight against tax planning with the inclusion of a test for merely preparatory or auxiliary activities used to escape from the characterization of a permanent establishment, and rules to combat artificial arrangements that cause the effective conclusion of contracts in the market country without characterizing the PE.

Action 7

Action 7 also proposes that, as the business essential activities of a company are carried out in a certain country, the company cannot benefit from the exceptions foreseen in the PE definition - Art. 5(4) of the Model Convention - to move away from

taxing the operations in the market country. It will be no longer possible to benefit from these exceptions by the fragmentation of activities between closely related entities.

Actions 8 – 10

Actions 8 and 10 deal with the issue of the expressive use of intangibles and its transfer to low-taxation countries, combined with the contractual allocation of risks and functions for entities located in those countries, without effectively having a business activity in these entities.

These actions try to realize the revenue allocation inside a multinational group, aligning it with the economic activity that generates this revenue. Many of the structures used in digital economy causes a separation of multinational companies functions, allocating them in different entities.

Other actions - Action 2

Beyond these previous actions, Action 2 will try to neutralize the effects of hybrid instruments used to reach the double non-taxation when, for example, two deductions are created for only one expenditure, or a deduction is created in one jurisdiction without the correspondent inclusion in the basis of calculation of the other jurisdiction.
Other actions - Action 5

Action 5 examines intangible regimes to determine when they are harmful preferential regimes under the Report of 1998 entitled "*Harmful Tax Competition: an Emerging Global Issue*". It is also required in Action 5 the existence of a substantial activity in any preferential regime, parameters to assess the substance were defined in the report of this Action.

Other actions - Action 4

Action 4 proposes better practices to change the domestic legislation and reduce BEPS opportunities through interest payments and other deductible financial payments. This proposal is based on a rule of proportionality that limits the deductibility of paid interests (or interest equivalents) by an entity in relation with a specific percentage of EBITDA.

16. VAT

For the implementation of the destiny principle, the VAT systems should have a mechanism to identify the sales destiny. Due to the fact that the VAT is applied transaction-by-transaction, the systems should have rules concerning the "taxation place" that will deal with all transactions, building indicators to show where the goods and services will be used by the company in the production or distribution process, or effectively consumed, if its the case of the final consumer.

In the case of goods commerce, the VAT application depends on the goods location in the moment of the transaction and on the location as a result of the transaction. In exports, the goods are VAT free in the exporting country, while the imports are subject to the VAT in the same basis of domestic sales.

The VAT in imports is charged at the same moment of the payment of customs duties, but there are some countries that charge in a posterior moment, upon a declaration from the importer for VAT purposes.

For B2C transactions, implement the destiny principle and trust on the self-assessment done by the consumer in the jurisdiction of residence is risky and will probably result in the no-taxation of the VAT in the services rendered. The reverse method, that operates relatively well in B2B businesses, are considered less effective in B2C, because it would need final consumers to make the VAT issue on services acquired in foreign countries. Besides that, it would result in the collection and inspection of small transactions of a large number of people, what does not seem reasonable.

16.1. VAT and small value godos

Many countries give an exemption for the import of small value goods, due to the administrative costs of charging the VAT and the low return.

These countries do not consider cost-effective to inspect the cross-border commerce of small value goods. Because of this exemptions for small value goods, usually between US$ 50 and US$100, are provided by law.

In Brazil, 100% of the objects are monitored in the postal service and in the express delivery, with the use of scanners for a not invasive analysis and a risk management system (currently in express deliveries and in the future in postal services). A standard team to perform this activity is constituted by five people, who inspect one hundred thousand objects per month.

It is more difficult for a postal service to establish a risk management system, because this depends on international arrangements between postal services and on the standardization of data to compose these systems. In express delivery, the courier services have their own systems for data exchanging that are integrated with the Customs risk management system

17. B2B SERVICES TRADE

<u>IRRF</u>
For countries that tax services at the source, the service user in the market country should collect the withholding income tax when he realizes the payment to the service provider. Banks act as intermediaries and auxiliaries of tax administration. The intermediary should be in a condition in which he can play this role reasonably. In B2B

transactions it is reasonable to assume that the acquiring company will do the withholding at the source. The intermediary task can be facilitated with the creation of a system of mandatory register for non-residents that remotely commercialize goods and services to residents. Difficulties appear when the intermediaries are located in third countries.

VAT
Usually when the consumer is resident in a different jurisdiction of the provider, the service is VAT free in the provider jurisdiction and subjected to VAT in the consumer country. A good policy is to oblige the non-resident service provider to register himself in the consumer country and to collect and remit the VAT for the consumer country.

When the service user is a VAT company registered, the tax can be collected by means of reverse mechanism, which changes the passive subjection from the provider to the consumer. The company, in general, can credit this VAT to compensate the final VAT.

18. B2C SERVICES TRADE

B2C

The issue toughens in the provision of services in B2C transactions.

The B2C commerce can drastically reduce the supply chains, eliminating the necessity of wholesalers, distributors, retailers and other intermediaries that are traditionally present in the intangible goods commerce.

Countries have difficulties on identifying where the services are rendered, to monitor such renderings and correctly charge taxes, especially when companies are selling services in countries with none physical presence.

Implement the destiny principle and trust in the self-assessment done by the consumer in the jurisdiction of residence is risky and will probably result in no taxation of VAT in services rendered.

The reverse method, that operates relatively well in B2B businesses, are considered less effective in B2C. Besides that, it would result in the collection and inspection of small transactions of a large number of people, what does not seem reasonable.

19. CONCLUSION

The confronting of challenges posed by the digital economy is making relevant progress through the Digital Economy Tax Force that developed the Action 1 of the BEPS Project.

The monitoring of the implementation of BEPS measures and of the results achieved will bring more clarity about the measures proposed to combat the BEPS phenomenon, in a general manner, and about whether this measures will be also efficient to the digital economy.

The period after BEPS will also accompany the domestic measures implemented by the countries, such as effectiveness and efficiency of withholding income taxes for services provided by non-resident companies and the implementation, by the market countries, of systems to register non-resident entities that provide digital services in these market countries.

A more audacious step that can be taken in the future is the definition of virtual economic presence in market countries and the enlargement of the permanent establishment concept to contemplate these new limits to the PE.

Topic 2.1

THE TAX CONTROL OF THE DIGITAL ECONOMY

Raúl Zambrano
Director of Technical Assistance and ICT
(CIAT)

Contents: 1. The tax control of the digital economy. 2. New business models. 3. Some new trends. 4. Digital cash, encrypted coins and other things. 5. Challenges to the tax administration. 6. Electronic documents and information close to the moment of the transaction. 7. Analysis of large volumes of information and prediction. 8. Practical example.

1. THE TAX CONTROL OF THE DIGITAL ECONOMY

Before the advent of the Internet, it would have been impossible to imagine having truly global markets where more than one billion people would be purchasing products called applications directly from the comfort of their home, their workplace, their seat on the bus while they return home from the classroom or the beach.

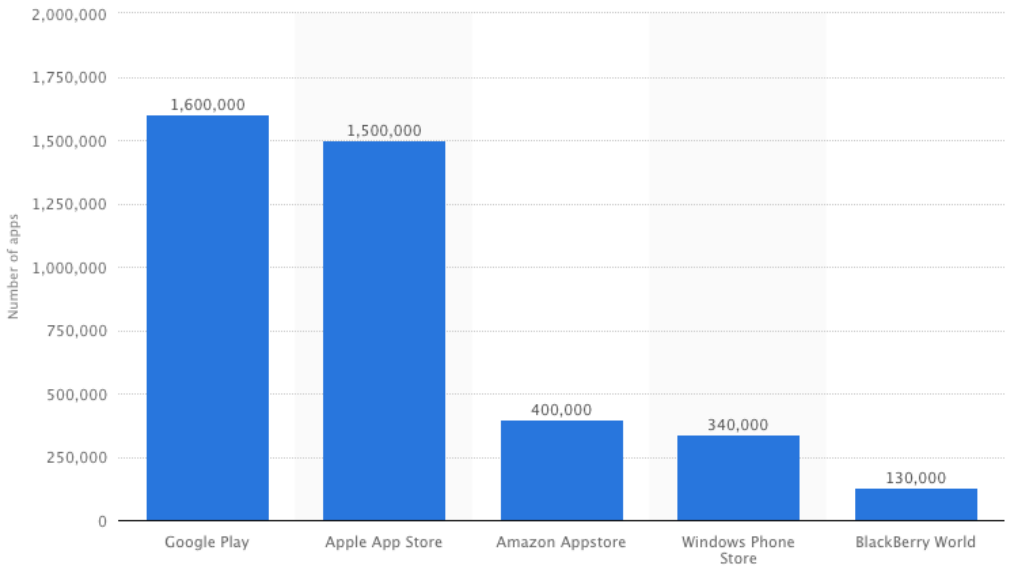


Figure 1 number of applications available in the main applications stores in July 2015[1]

1 Source: http://www.statista.com/

Most of these applications are aimed at end users, real individuals who use a mobile device that normally fits comfortably in their pocket or purse. According to data from the 2014[2], the average number of applications used regularly in a month on each smart mobile device was 27. Those are actually used in the month by the average user who probably has one greater number of those applications installed. To get an idea, the number of users of the WhatsApp application reached, according to reports, 900 million users in the world[3] while it is estimated that the number of downloads of applications in 2017 will reach 268 trillion of downloads for a value of global market of about $ 80 billion. On average, in 2014, the number of applications that are used every month on each device is close to 30[4]. The numbers are certainly spectacular. The technological development achieved in a relatively short time is impressive. Although there were already some previous advances, this very efficient distribution model of applications can be associated with the year 2007.

Some of these applications may be the result of the research efforts of a developer wanting to experiment with new toys in his spare time, but the vast majority are associated to economic activity, although sometimes it is not obvious. Developing them require paying wages, buying equipment and hiring services. In its operation are sold and buy assets, tangible and intangible, lend themselves and contract services, subscriptions are marketed or sold to third parties, under different models and forms, advertising and information.

A simple multiplication tells us that we have available tens of billions of points of sale, distribution and payment for transactions. We could ask ourselves if, following the growing numbers of computers, users, and applications, the transactions made by internet have now the same relative importance as transactions made in the physical world, since Consumers use their electronic media for many things but leave more important, personal or higher-value transactions to perform them in the physical world facing local and physical business. A study of 2011[5] points out that the 3.4% of GDP of the developed economies was already connected to the Internet, and the number continues to grow.

According to Forbes Magazine[6], the list of the 100 most valuable companies in the world includes 12 companies in the technology sector, including the first three, which are added at least 2 telecommunications. This is far more than 15 or 20 years ago, when energy or financial companies occupied greater relevance. Then, in addition, tech companies concentrated their products on physical computers, while today, at least, significantly, much of the products or services that are marketed are directly related to the digital economy.

---

[2] Source: http://www.nielsen.com/us/en/insights/news/2014/smartphones-so-many-apps--so-much-time.html

[3] Source: http://www.vcpost.com/articles/89730/20150907/facebooks-whatsapp-reached-900-million-monthly-active-users-aims-1.htm

[4] Source: http://www.nielsen.com/us/en/insights/news/2014/smartphones-so-many-apps--so-much-time.html

[5] Source: "Internet matters:" "The Net´s sweeping impact of growth, jobs and prosperity". McKinsey Global Institute.

[6] Source: http://www.forbes.com/powerful-brands/list/#tab:rank

Recent technological developments associated with the digital economy allow that many companies actually operate in global markets; it is possible to perform operations without any physical presence in a given jurisdiction. These operations include goods and traditional services marketed through the Internet; intangible assets and non-traditional services provided directly through the Internet, and with the presence of 3D printers, even goods that can be "3D printed" through downloads made by the Internet.

2 NEW BUSINESS MODELS

In the digital economy, several business models have been developed:

2.1 B2C operations. From goods to intangibles and subscriptions

B2C, Business to consumer operations, are among the first models of the digital economy. Some companies operate their online stores as extensions of their physical stores. In other cases, the operations are exclusively managed through virtual stores. Goods and services marketed may be physical to be delivered in the domicile of the buyer, as sales (Amazon), or they may be intangible to be downloaded over the Internet, this includes e-books, music or movies (Amazon, iTunes) or be consumed online (Netflix, Spotify) as well as magazines and newspapers that sell their digital versions. Service providers can work in different sectors and with various types of applications, including traditional services that are managed online (PayPal and banks applications) to others such as graphic design, translation and editing of texts.

There are a number of free applications and services. Examples of these services include electronic mail (Gmail, Yahoo!), storage space (Dropbox, Apple Drive, and OneDrive), take notes taking and synchronization (Evernote, OneNote). Also: collaboration in editing files (Google Docs), hosting of Web sites (Amazon), virtual machines (Bitnami), instant messaging (WhatsApp), telephony or something similar (Skype) notification of news (Flipboard, Digg, Reddit) blogging (Blogger), microblogging (Twitter), social (Facebook networks, LinkedIn), platforms for sharing photos (Instagram) or videos (Vine, Vimeo, YouTube), music on demand (Spotify), etc.

Those companies earn their incomes with different business models: simple and basic things without cost, sophisticated paid benefits; a non-negligible amount of storage free, more than that is paid; all free service in return for accepting advertising, usually customized to frightening levels. All free service in return for accepting that more or less anonymous information about our habits and preferences is sold online to third parties; free with advertising or payment free of advertising, and so on. Free for a time of sample, with the option of opting out of service after trying it.

2.2 B2B operations. The cloud and the "things" as services

Business to business operations are perhaps less popular and well-known, but are very important in terms of amounts. An important part of these operations are supported, first,

via the possibility of interconnecting platforms to carry out transactions of goods and services in a very efficient way and, second, on the integration of logistics services. Another important part is very diverse support to outsourcing, such as hosting of services computing, auction management, management of interviews for recruitment or translation and publication of documents. Unlike what usually happens in relation to operations with end consumers, in transactions between business, prices may vary and may depend on several factors, including the volume of products, but others, such as the cost opportunity and certainly the relationship that may have between them related parties. Consequently, the implications from the point of view of taxation are certainly higher.

Cloud services are of particular importance.

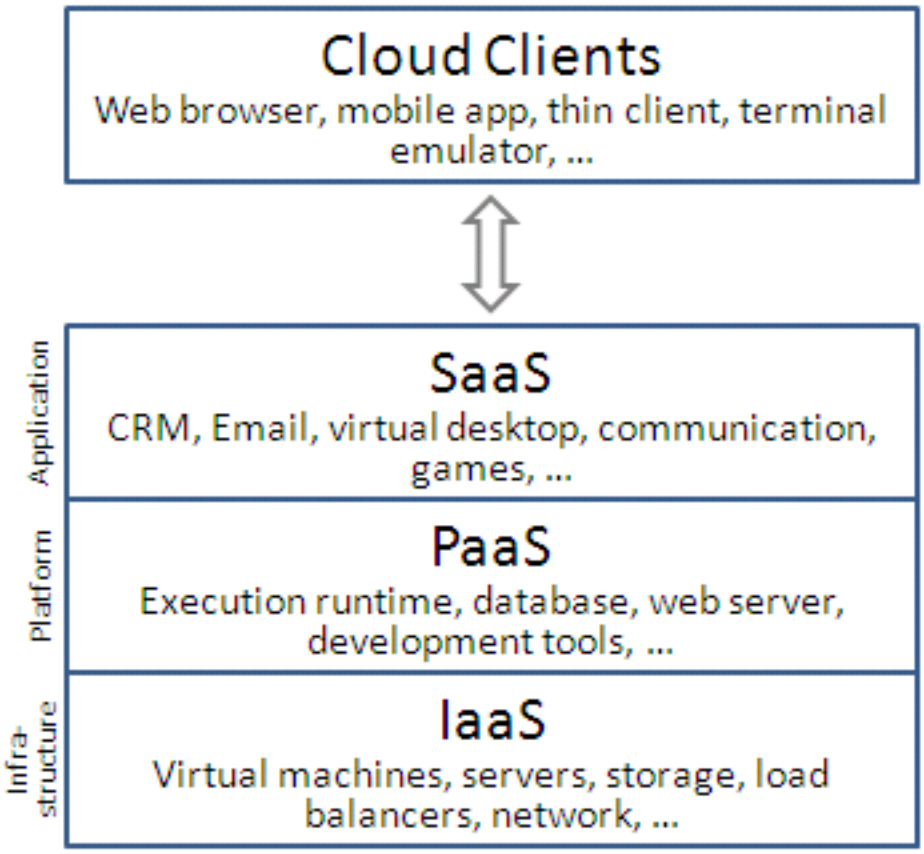


Figure 2 diagram that represents the stack format of cloud services.[7]

Some of these services are provided to consumers, e.g. email, but most of them and in growing importance, are companies. The way they operate these services is particularly important. For example, if an organization needs for a few days a year ten times more computation power, it will not need to carry out a process of acquisition of equipment that will be underutilized after the peak time. If a company needs to double the available storage, you don't need to order new disks, expected to arrive, install cabinets and

[7] Public domain.

initialize them, you only need to modify online rental space and in a few moments it will be available.

Models include the mode of infrastructure as a service - IaaS, which includes virtual servers, storage, balancers, computer network; platform as a service - PaaS, which includes databases environments, servers content or development environments; and software as a service - SaaS, which includes all applications from e-mail to office productivity, the application of Google or Microsoft are examples of these services.

2.3 C2C operations

Transactions from consumer to consumer are increasingly frequent in the digital economy. Users sell or rent goods or services directly to other consumers, sometimes on a set price with auction system. Intermediary services that make available the platforms where these transactions occur are provided by companies that facilitate the Exchange. Some of these services have reached very large dimensions, for example: eBay, for goods; Uber, for transport of persons; Airbnb, for lodging; or Bliive for services.

This type of transactions, as in previous cases, can have different actors in different jurisdictions. Particularly complex is the theme for the tax administration when the seller or latest service provider are in the jurisdiction, but the company owner of the platform or application that facilitates the transaction in a third generation.

3. SOME NEW TRENDS

There are some new developments in the digital economy that will have some importance for tax administrations.

The value of the data

There is currently a huge ability to collect large volumes of data from users of Internet sites and applications; these can be made directly from transactions, or indirectly through the use, navigation, frequency or other habits of users. This can be done with an explicit or implied users' agreement, or sometimes without any agreement on the part of the users. Data and their treatment allow companies to match sites, and experience with the particularities and specific user preferences, but they also allow, for example, distribute to targeted users specific advertising and selling that advertising to third parties or sell data to third parties. This makes it possible, for example, that if we read a newspaper in English from Panama, we offer advertising to British expatriates in Panama. Or, if one day we got to look on a package tour to the Greek Islands related advertising us appears in half of our wall, in the lateral columns of the newspapers that we attend, or in our mailbox.

It is clear that these data generate value in the products of these companies. It is not as clear as quantified that value, inter alia because the same data may have very different sizes for different companies depending on that you can do with them. The tax implications of the value of such assets may be complex.

On the other hand, on the basis of the fact that those who contribute and who collect the data can potentially be in different jurisdictions can generate questions about whether they are or not a kind of commodity raw material that is exported and imported with its subsequent consequences.

The value of the content

Another trend that can be observed on the digital economy is that some companies' applications, or computers on which they run, are fundamentally the vehicle to deliver content, and that content provides the company's revenues. In the traditional economy, the business of printers or photographic machines came to have a similar behavior, with very low consumption and a concentration in consumables equipment. In the digital economy, similarly, readers of books or magazines applications are distributed free of charge, but content are sold via subscriptions sold content, in this case electronic versions of the traditional content of paper, usually with additional features impossible to achieve in the print medium. Some teams and some applications become a kind of "*commodities*' to have a value of zero or close to zero as companies seek revenue from services and special features, additional content, advertising or the treatment of the information of the users. As examples illustrating this process we can find low cost tablets or many mobile apps that are free of charge and which allow users to buy from them, for example magazines issues or lives and special powers in games. For a game company their Star products and their greatest asset is distributed free of charge in several platforms and many markets, and obtain billion dollars per year by asking their users to extend their lives or gain special powers.

3D prints

Other recent developments are the 3D printers that can build solid objects from models or designs. They are still in the preliminary stages; they have potential for future development since they can dramatically shorten the distance between the place of design and the manufacture of certain products. From the point of view of the tax administration, they would make possible to purchase goods which are downloaded over the Internet and do not pass in their process through border points, ports and airports.

4. DIGITAL CASH, ENCRYPTED COINS AND OTHER THINGS

Another important development is the use of different forms of electronic money.

- Intermediary payment service systems.

  There are some payment services established by third parties that allow a user to purchase goods or hire services in e-commerce sites or applications without having direct access to any financial information of the buyer. Using these services, the buyer performs a financial transaction with the intermediary service provider and the intermediary makes the payment to the seller. These applications are popular because they give more security to users about the use of its financial means as well as the details of their identity. In other cases, users can promote these services to keep privacy on their consumption or habits or accessing goods or services in another jurisdiction, which for various reasons cannot be accessed with their own financial means.

- Quasi-coins within specific systems

  There are some systems where there are species of internal virtual currency that can be used to buy goods or services, virtual or real. Sometimes these can be won within the application itself, or by actual purchases. Others can be purchased with real money used for transactions.
  Examples abound. They are the shops, airlines or credit card loyalty programs; virtual currencies or *tokens* that can be used to buy things in games, such as *CandyCrush,* and betting systems; transactions in simulated worlds, environments of entertainment for adults; or barter systems such as as Bliive.

- Encrypted coins.

  Bitcoin is an encrypted digital currency supported by very complex algorithms. Imagine for a moment that it is a bank account accessed over the Internet, which allows you to buy things, or make transfers. Now think that the Bank does not exist, and that it is a network, deployed globally, that collectively manages all transactions. Instead of a trusted third party, there is a network of peers. Think for a moment that it is as if all customers of a Bank have on their own computers all transactions and all balances of all accounts. The third party would not be necessary. Of course, when performing a transaction, it must be carried out collectively by the network, not a centralized node; for this reason, any transaction required 10 minutes to be completed, this in contrast to centralized systems in which typically a transaction may take a few seconds.

To have an account, it is required to create a pair of public and private keys that are unique. The public key that is freely known is the address of the account that has the balance of bitcoins. To access the account and use their balance, the private key is required. Without the private key, you cannot access your account. If for any reason a person loses it, the money is simply lost. There is no third party to report the loss. Addresses of bitcoin can be kept in a wallet of bitcoins. To fill the wallet, you only need to acquire some bitcoins, which shall be deposited in the public address by some exchange agency service. Another way is to receive transfers from other directions under, for example, sale of goods or provision of services.

All transactions from an address and their balance is public and visible to everyone. Global transaction log called "block chain" allows confirming that who transfers the funds actually has them and that these balances are not spent more than once. The existence of this log can induce us to think that this is traceable, so it would make it possible to identify the participants, in all transactions. In addition, to know what happens to the money once received. However, as each beneficiary can create a new address for each operation and as it is not necessary to identify who spends, the probability of maintaining anonymity of transactions is relatively high. To receive the funds, the receiving party must use their private key to sign the message.

The total amount of Bitcoins which may enter into circulation is not, as one might mistakenly think, infinite. The number to be reached is 21 million, and this will be reached by the year 2140. 21 million currency units do not seem too many, but if we take into account that each bitcoin can be split into satoshis (one hundred million parts per unit), the total number of fractions is enormous. A consequence of the limited and relatively low number of possible units means that it will not be devaluated easily. You could say that it seems a little like gold or gemstones, which are in limited amount that we must find them and polish, but instead of miners who dig in the Earth, there are miners must solve very complex algorithms. Rather than obtaining a diamond as a reward for their work in mining, these miners get bitcoins.[8]

Intermediary payment services are entering a stage of prosperity. It is not only operators such as PayPal which incidentally begin to explore their e-wallets for shopping but the participation in media payments managed by other companies not necessarily traditional actors in the financial sector. Examples abound: mPesa in Kenya supported by a TELCO, to solutions of payment from companies like Google and Apple; payment platforms supported directly by stores or groups of them. Many of these solutions are centered on a single market; they will be of interest for that administration, but many of them are already have expressed the intention to be present in the future in international markets.

[8] Taken from: http://www.ciat.org/index.php/es/blog/item/129-una-historia-de-vampiros-ii.html

In terms of information, the one who wants maintaining anonymity is probably going to prefer cash or will seek electronic media closer to anonymity, as precisely encrypted coins. It is clear that these operations can be, at least for now, small in volume.

Internet of things

The connectivity to the Internet is no longer confined to computers and mobile devices, but it also includes a growing number of other equipment ranging from vending machines to automobiles, home to industrial machinery equipment and with it increases exponentially the amount of information that these computers can be collected and the ability to measure things very accurately. On the one hand, this allows expanding the influence of the data in the value chain of different production processes, but it will also allow knowing a number of facts accurately.

5. CHALLENGES TO THE TAX ADMINISTRATION

The tax administration to the digital economy faces several challenges. In general, these are the same challenges always and others created precisely by characteristics inherent to the digital economy.

The same problems as usual

The problems faced by the administrations in the traditional economy also faces them in the digital economy. These can be mitigated by some in cases where control mechanisms are simplified precisely because of the use of electronic means, e.g. updating the records of taxpayers or the processing of tax declarations, but in other cases, the problems are exacerbated by the digital economy.

If an administration has problems with companies that are almost fictitious, operate for short periods, with the single intention of parties to fraudulent mechanisms related to the tax credit in the VAT, these problems can potentially persist or worsen because those fraudulent transactions can be done very efficiently. During the short time of operation, the number of fraudulent transactions may be much greater than in the current economy.

If an administration has problems to address compliance in terms of issuing invoices to final consumers or to use, for example, equipment tax on retail sales; It surely face equal or greater problems with those taxpayers who make sales through web sites or mobile applications.

If an administration has major problems in relation to the informal economy, surely also face problems related to the operation of B2C sites for sale or rental of goods and services direct between taxpayers.

In addition, the problems of erosion of the tax bases and the transfer of profits to other jurisdictions can be really exacerbated in the digital economy. On the one hand, for technology sectors, it may be relatively easy to move their operations, or part of them to other jurisdictions and from there make their transactions. Even more, things like the

application of cloud or 3D printing services can radically change certain business processes in a way that movement can be very efficient and almost transparent for the management of the business. Considering that some taxpayers deliberately intend to carry out such operations with the sole purpose of reducing the tax burden, this potential requires us to put the focus on the associated risks. On the other hand, in the digital economy it is viable that a company perform significant transactions in quantity and value in a certain jurisdiction without having any physical presence. They are essentially operating from abroad via their Internet sites or its applications, hiring advertising space to third parties, who may or may not be in that jurisdiction, and accumulating significant amounts of information from the users in that country. Under these criteria, issues such as the identification of permanent establishment, the implementation of double taxation conventions or the treatment of transfer pricing face new challenges.

Grey borders and dark places

To the difficulties associated with the traditional economy, we have now to add the digital economy issues, which have no parallel, at least not in the same dimensions.

To correctly apply certain norms, the administration or the taxpayer should probably determine the place where one or more participants actually are, to be able, for example, to apply a withholding tax on a payment or apply a particular tax, which would be particularly important in scenarios in which applies a VAT criterion of destination for international business transactions.

However, that simple task would not always be easy or even possible. The criteria available to identify the place include the IP address, the country of issuance of the credit card, or the country that the user identified when they open their account. These alternatives are all valid even though they would not necessarily always have the same result.

However, these alternatives become insufficient if taxpayers want deliberately to appear to be elsewhere or simply want to create difficulties for third parties to determine their location. With the use of VPN systems[9] or the dark web browsers, it may be impossible for a business to determine the place where their customer is actually located. For an administration, it could be extremely complex and costly and would not be viable to apply massively to all transactions.

The use of the jurisdiction issuing of the means of payment can be outlined through the use of intermediary services of payment, which could collaborate or not with the Administration, but that hardly would share that information with the businesses for individual transactions.

[9] Virtual private networks

But this alternative is actually excluded in the case of the use of coins encrypted as Bitcoin, in which there is no central point of control, in which case the jurisdiction of issuance of the means of payment simply does not exist even as concept.

The use of mechanisms to obscure or hide the IP address from which you can usually identify the place where someone is, the use of intermediary services of payment and in particular using Bitcoin, may be common in illegal activities, whose treatment goes beyond the tax issues. However, it should be remembered that not all users of these services are involved in these activities. There are reasons for legitimately some users prefer to use VPN networks in their connections to ensure that all data are encrypted and therefore are not easy interception by someone in the middle. Payments made through third-party services ensure users that their personal data and their cards are protected. The use of encrypted currencies will be attractive in transactions where you would rather operate cash for anonymity, but also as a means to solve situations such as for example limitations on access to foreign exchange.

Options and alternatives

The first option that the Administration has against the digital economy is doing nothing different from what is done in the real world. For now, in several countries, the size of the purely digital transactions is residual. By its own property, the size of the fraction of each economy that takes place in bitcoin is difficult to estimate. No doubt, when the number of establishments that accept bitcoin as regular payment increases, we will know that in a certain jurisdictions the size of that fraction is already not negligible.

The difficulties associated with the digital economy include its operating speed, always increasing in size, the potential of operating in global markets is particularly complex in the case of intangible assets and subscription services, and the possibility of using tools associated with the digital economy in relation to move tax and transfer winnings to other jurisdictions. The administrations could treat them similarly to the way that it handles the traditional economy, without including or excluding particular considerations. After all, there are tax rules, and taxpayers should comply.

In this way, an administration can, as several administrations do, obtain available information associated with periods of work through transactions carried out with third parties information including purchases and sales, payments of interest. They can validate that the accumulated amounts in the detail of the entire period coincide or are within reasonable margins with the statement made by the taxpayer, or otherwise initiate a process of inspection.

However, we know that that is not enough; there are sectors and individuals who only comply if they feel observed closely by established means of control.

Administrations, on the other hand could pursue opportunities in developments related to the digital economy so that it is possible to better control processes and incorporate innovations aimed at improving compliance. Take advantage of the enormous power that

the digital economy offers to obtain and collect information to develop new procedures that are more effective. In this sense, it is clear, that the soonest is the information obtained from the specific transaction, the greater the ability of the Administration to act quickly.

With this capability the Administration can pass from a process of trying to find out things that were done wrongly in the past to punish the offender, to predict whether probable behaviors of non-compliance or the kind of response that the taxpayer before an action. We will have the possibility of acting faster, very close to the occurrence of the facts in a new culture of immediate response very different from a culture that the Administration had with the time of prescription as a fundamental element in the dimension of time. In some cases, this ability can contribute to behavior change.

In summary, these capabilities will enable us to switch from a control ex post in the traditional economy to a control almost simultaneous in the digital economy.

Administrations will have to face the challenges of digital economy-related tax control in internal and external environments.

In the external environment one, of the elements of interest for the international taxation and control processes are situations related to tax base erosion and profit shifting to other platforms. The implementation of the BEPS action plan, an effort of cooperation between various actors led by the OECD will establish responsibilities, difficulties, challenges and opportunities of the administrations. Cooperation and exchange of information between administrations will be increasingly necessary while responsibilities are established and specific obligations of multinationals, while in the case of the digital economy, simplified mechanisms will facilitate compliance by non-residents and others, intended to allow information about transactions. The BEPS initiative report should be approved and be public in October this year, so this document does not include them, but admits that some recommendations will be decisive for the purposes of tax control in the digital economy.

In the internal environment, in my opinion, there are several alternatives, which are described below (not exhaustively).

6. ELECTRONIC DOCUMENTS AND INFORMATION CLOSE TO THE MOMENT OF THE TRANSACTION

The use of electronic documents, particularly electronic invoicing that tax administration have all issued documents has a potentiality recognized for purposes of tax control. In a scenario in which most of the economy use of electronic invoices, checking the total credits and total from the value-added tax can be determined from a simple aggregation of the invoices. In fact, the availability of all invoices will release administrations from several formal duties as well as the report of information taxpayers given that has background information. The Administration can propose the VAT returns for the periods or at least validate them to identify errors or inconsistencies at the time of their presentation. Additionally, the aggregate information will have implications on other taxes,

for example from the invoiced sales, we can quickly identify if the annual income statement reports revenues is far below the total sales. Additional anomalies can be detected, such as e.g. taxpayers only accumulating tax credits or those who only emit invoices but do not have purchases. Other unique behaviors behind which fraudulent schemes may intend to improperly seeking replacement of so-called tax credits that don't exist than in simulated transactions or unregistered sales aimed to apparent lower income to lessen the tax burden.

But, in addition to information crossings, when the Administration receives information at a time very close to the transaction, or even when it authorizes prior each invoice, as for example in Brazil, the Administration has the possibility to act fast, allowing preventing situations of non-compliance with which would have major consequences.

In Brazil, for example, at the time of authorizing an invoice to validate if the buyer is a valid and existing taxpayer. If the registration is cancelled, the issuance of the invoice is not allowed, avoiding using registrations for fraudulent purposes.

In Mexico, one of the most important innovations is related to EFOS and EDOS. Due to the existence of e invoicing, and the analysis of these data, the SAT can identify mechanisms of tax evasion in which a taxpayer has been simulating operations to "sell" invoices to other taxpayers for the sole purpose of reducing their tax burden by applying so-called appropriations. The SAT after identifying the process, can make a list of the sellers of fake invoices or companies who bill simulated operations. These are EFOS (companies that have been issuing invoices without assets, personnel, infrastructure or material capacity to provide the services or produce the goods), with direct consequences for the buyers of these invoices or companies that infer simulated operations - the EDOS. These will such operations denied and so will have to regularize their tax status. The mechanism, which includes a fraud scheme using outsourcing schemes or "outsourcing" of staff, is covered in article 69-B of the Tax Code of the Federation. It was demanded for protections of revision, but recently is the Supreme Court denied the protections (amparos). The SAT has now a very important tool to combat this type of fraud.[10]

However, the use of electronic documents directly associated with transactions are not limited to invoices. For example, in several countries electronic withholding certificates are used so there is no need to wait for the statement of withholdings to know the amount that each withholding agent must actually pay at the end of the period. In addition, and perhaps most important, it is possible to know when to credit of that withholding was actually performed by a particular retention agent.

Make the existing information transparent

When the management have significant amount of good quality information of the economy received through third-party operations, it is a good practice to be transparent with the information available, either by publishing the total of income and expenses

[10] http://www.ciat.org/index.php/es/blog/item/330-una-aventura-temeraria-un-adjetivo-comun-ii.html

known by the administration or preparing the prefilled returns. Even if some information should not be disclosed, such as for example the one associate to investigations, it is usually good that taxpayers know that the Administration has information on their income and expenditure; it is a deterrent so taxpayers do not try to, for example, hide part of the income. The amount of differences resulting from the crosses will be significantly lower and the returns will be more accurate, at least in comparison to the already available information by the administration. It is true that many penalties and interest would be avoided but things would be better from the beginning and we know that the more we wait to correct a problem; the more the solution is difficult and probably more expensive. In addition, when we do not have to control what we already know, the Administration may invest its resources to other objectives.

Homes and electronic mailboxes

For the tax administrations, it is very efficient to be able to interact with taxpayers electronically. The use of electronic returns and services online are in tune with the trends of platforms for self-service by users. The possibility of having a secure electronic mechanism to give information to the taxpayer becomes particularly useful, and in particular to notify administrative acts. Processes are faster with this mechanism and reduce costs, but additionally gives certainty to taxpayers about the cast acts and evidence of delivery of documents, the moments of their opening and reading can be managed and seen. The mailbox is not a private mailbox but one under the control of the administration.

In Argentina, the AFIP, via General resolution No. 2109 the 2006 regulates the electronic address. It defines it as "the site secure, personalized, valid and optional recorded by taxpayers and responsible for the fulfillment of tax obligations and for the delivery or reception of communications of any nature". Many administrative acts may be notified by means of electronic communication. They are citations, notifications, warnings by lack of payment and presentation or other acts issued with facsimile signature; location of temporary payment of overdue taxes; summons for lack of presentation of determinative affidavits of resources of social security. Initiation of the process of application of fine notice issued by computer data system; and, citations, notifications, subpoenas or notices issued by the AFIP in relation to Web services. The acts are notified the day that the taxpayer proceeds to the opening of the document or Tuesdays and Friday immediate after the date that the documents are available in the virtual window.

In Spain, the enabled electronic address - DEH is used to receive administrative notifications that the General Administration of the State and all its bodies can issue. This is a mailbox is in which messages and procedures for notifications will be received. The system is of a general nature to the public administrations and in particular to the State Tax Agency. It has indefinite validity and cannot be eliminated or disabled. The mandatory users are: companies, legal entities and all entities which do not have Spanish nationality, branches and permanent establishments of non-resident entities, company and interest groupings, joint taxpayers in the regime of large companies and subjects to the tax

consolidation of tax system. The mechanism serves for all communications and notifications that perform the tax agency in foreign trade tax, customs and statistical procedures and revenue management of other entities. The electronic notification has becomes the usual form of notification.

In Brazil, the Receita Federal established the portal e-CAC (*Centro Virtual de Atendimento ao taxpayer*). From March 2011, the collection services related to debits in DCTF are sent to electronic taxpayers' boxes. These notices are equivalent to a friendly collection and the taxpayer has 30 days to regularize their situation, avoiding that theirs debts are registered as active debt. The Receita has made available to taxpayers the option of the *home tax electronic* -DTE, which allows the e-CAC postal boxes are also considered as tax domicile. Accession has great advantages; the main one is that communications and notifications of the official acts are considered delivered a fortnight after the message was recorded in the email box. Only after those fifteen days, it starts counting deadlines, i.e. you will have fifteen days to prepare, for example, challenges or resources. Other facilities include the possibility of registering mobile phones to receive notices of new documents, the reduction of time in procedures for digital administrative processes and ensuring tax invisibility and total security against the loss of information. It also allows access to all existing digital processes in which they are parties in the Receita Federal, the Finance State Attorney and the Administrative Council of the tax resources. It is accessed is via digital certificate.

Really anonymous complaints mechanisms

Some administrations provide platforms of anonymous complaints supported by call centers or in sites on the Internet that does not request users identify themselves and which do not capture any information session.

An alternative that provides more reliability to the users is to open an administration website to receive complaints in the "dark internet" and eventually make payments of rewards in encrypted coins.

Specific applications for audit

The amount of data available to the Administration has reached unimaginable volumes some years ago. In some countries, for example you can count with the details of all the invoices issued and received by a taxpayer, the details of their retention, and information related to the taxpayer of tens and hundreds of sources of information. Programs are developed with information from monitoring and actions of fiscal control of mass character, but it is needed in some cases processes of individual control of a more general nature. In these cases, it is convenient that the tax auditors have appropriate tools to be able to generate partitions of all data of a taxpayer and have them available for the audit, either through remote access to central systems by downloading data to local teams. These applications must be prepared to manage, build, resample, normalize and analyze that information and its sources. At the same time they should protect taxpayers and involved third parties information allowing, when necessary, preserve their anonymity or hide data that must remain confidential.

7. ANALYSIS OF LARGE VOLUMES OF INFORMATION AND PREDICTION

The use of tools data analysis for large volumes of data (*BigData*) and their risk management allows exploring options for suspect situations of non-compliance and predict the result of the actions of the administration.

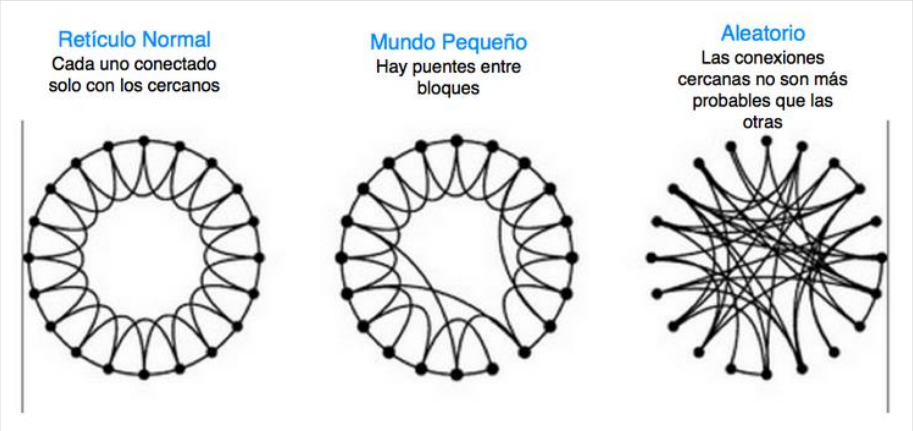
Tax administrations should develop some of the following techniques and tools:

- Permanent data (StreamSQL) workflow management

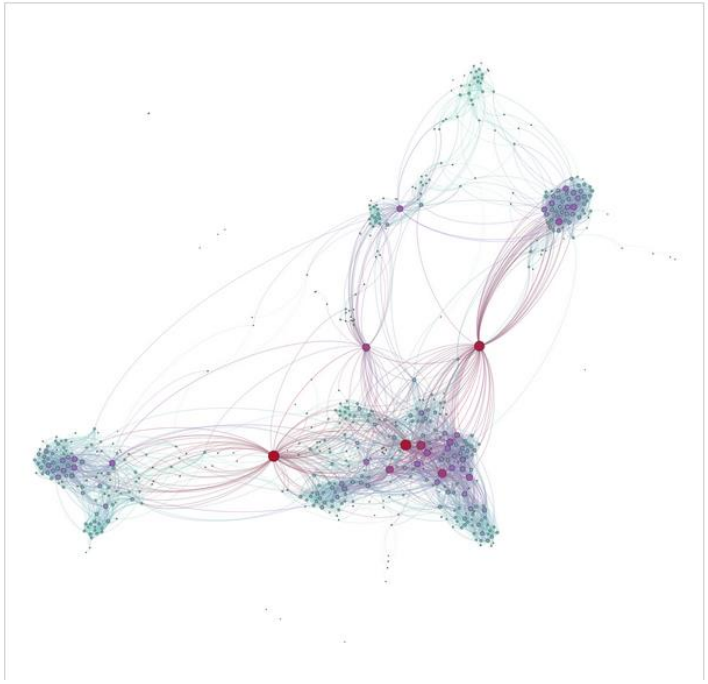
  It allows to receive data on transactions, activities, contacts that identify, or create hints of non-compliance events, as soon as the data arrive, to trigger certain processes.

- Analysis of social networks

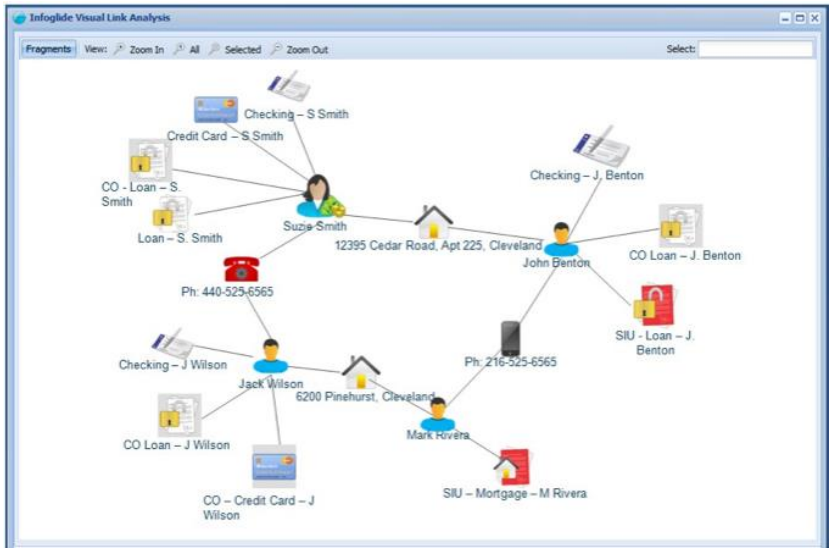
  Through transactions carried out between them, taxpayers share information (IP, numbers of contacts, executives, accountants) that make up networks. In situations of non-compliance, these social networks form models of the so-called "small worlds" from which analysis operation schemes for fraudulent process can be determined.



  Graphs that identify the potential concentration of groups, for example, economic sectors, frequent relations with large taxpayers, but also participants in certain schemes of operation can be identified from the identification of those links or connections between taxpayers.



With the use of proper tools can analyze and assess these relationships.



- Prediction of circumstances of non-compliance

  One of the most important areas of work is the use of mathematical and statistical models oriented to determine or predict results, from the existing data under certain criteria of probability and reliability.

This analysis can be done by statistical methods or computer artificial intelligence techniques such as expert systems, neural networks, and particularly the so-called learning machines (*machine learning)*.

- Statistical analysis and regression.

  The use of statistical analysis and the generation of models tailored to the observed data can be used to identify non-compliance, historical analysis of compliance factors, expected levels of return on investments, and other factors.

  The statistical analysis and the use of adjusted models should be adjusted and prepared for working with large volumes of data, solve the problems of non-existent information, preparation and validation of prior information.

  Of particular interest will be the logistic regression (*logistic regression)* used to determine classification models, could for example be defined to determine that taxpayers are going to be verified or audited.

$$P(\mathbf{x}) = \frac{\exp z}{1+\exp z}, \quad z = \sum_{j=0}^{K} b_j x_j \qquad \ln\left(\frac{P'}{1-P'}\right) = a + bX \qquad \frac{P}{1-P} = e^{a+bX} \qquad P = \frac{e^{a+bX}}{1+e^{a+bX}} \qquad \frac{P(\mathbf{x})}{1-P(\mathbf{x})} = \exp\left(\sum_{j=0}^{K} b_j\right) = \prod_{j=0}^{K} \exp(b_j \qquad Ln\left(\frac{P}{1-P}\right)$$

  A very good example can be found in a study on factors affecting taxpayer compliance[11] of a region, in which it was determined that the factors that influence effectively the compliance (positive or negative) are the probability of being audited, financial constraints, changes in legislation and their lack of knowledge about it.

[11] Journal of Tax Research. Tadesse Getacher Engida and Goitom Abera Baisa. https://www.business.unsw.edu.au/research-site/publications-site/ejournaloftaxresearch-site/Documents/07_EngidaBaisa_FactorsInfluencingTaxpayersCompliance.pdf

Variable	Coef.	SE	Z
Tax knowledge	0.68	0.45	1.51
Probability of Auditing	0.31(*)	0.18	-1.72
Perception of Government Spending	-0.1	0.14	-0.72
Perception on Equity and fairness	-0.1	0.17	-0.56
Penalty rates and enforcement	-0.14	0.17	-0.83
Personal financial constraint	-0.25(*)	0.15	-1.71
Changes on current government policy	-0.26(*)	0.15	-1.78
Referent group	-0.21	0.17	-1.29
The role of the tax authority	-0.09	0.13	-0.66
Log likelihood	-75.36928		
LR chi2(23)	29.2		
Number of obs	99		

Notes: ***p <0.01, **p <0.05, *p <0.1.

- Machine learning and data mining

  It is the use and adaptation of algorithms that allow systems to learn and make predictions from exploratory data analysis, the determination of patterns, mathematical optimization. They are among the closest to the administration techniques is the use of decision trees, rules of Association of variables, neural networks, clustering algorithms (*clustering*) to segment cases.

  An example of using machine-learning techniques can be seen in the IRS program to identify applications of possibly fraudulent tax returns using techniques from *clustering* to identify potentially risky statements involving identity theft.[12] The process allows identifying some elements such as the use of common domicile addresses, senior citizens or persons in prison.

  Another example: a model that predicts the estimated result of an audit adjustment was built[13]. The model is developed "training" the application with data from all previous audits and considering the different available variables, for example relationship between purchases and sales, volumes of investments, economic activity. These models, evaluated in terms of their performance, proved to be more efficient than other methods of selection.

[12] https://www.treasury.gov/tigta/auditreports/2015reports/201540026fr.pdf

[13] Improving the tax administration with data mining. Danielle Michi barrier and Satheesh Ramachadam. https://www.treasury.gov/tigta/auditreports/2015reports/201540026fr.pdf

These examples the incorporation of elements of Bayesian analysis becomes particularly important in the assessment of risk in order to incorporate new information and evaluate how it affects the new information in the detached from the risk management actions.

- Internet of things.

  Among the new developments that can support the tax administration is the incorporation of sensors and devices that can provide direct information of the activities that can be used both in verification processes and the use of presumptive methods of data. The application possibilities are varied. They include such diverse applications as flying devices taking pictures of buildings to identify modifications or improvements and verify whether they were or not declared, or counters for customers that enter a restaurant.

In all cases, a determining factor to enable administrations to leverage these elements will include the incorporation of people with the skills and knowledge to work with the enormous and growing information; but also that officials already working in the Administration to be trained, trained, and to adapt to new times and new ways of doing things.

8. PRACTICAL EXAMPLE

A tax administration can send via emails informational messages to taxpayers. These messages can be general or specific and personalized to the taxpayer. You may a priori consider that all e-mail sent by the Administration will be received and read by the recipient. However, emails can be simply ignored or discarded without even being opened by the user, by the configuration of the mail server, by put in configurations of network security equipment, by anti-spam filters, by lack of interest of the reader or a simple error.

In a real analysis 300 000 sent e-mails were discussed and it was noted that 86% of emails were not opened. The number of emails that are not opened can be a disincentive. Some variables were then considered:

- The time of day, day of the week or month in the year in which the mail was sent. We want to determine if the hour, day and month when a mail is sent has any incidence on its probability to be read.

- The domain to which the user is registered
  Users can register with an email as of their work, for example @ciat.org, or can use a generic email account like @gmail.com.

- The identification of the author of the mail
  Is it relevant if the mail is sent by the tax authorities, by the administrator, or by a Regional Administrator?

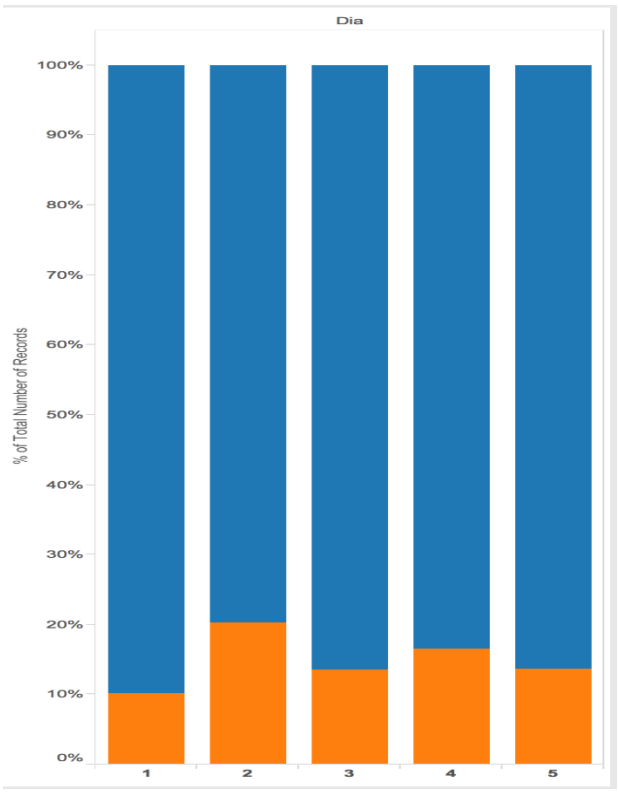
- The length of the text of the mail
  The length of the message. Is a short message more likely to reach their destination than a long one?

- The length of the subject in the email is sent.

The table below gives a summary of data:

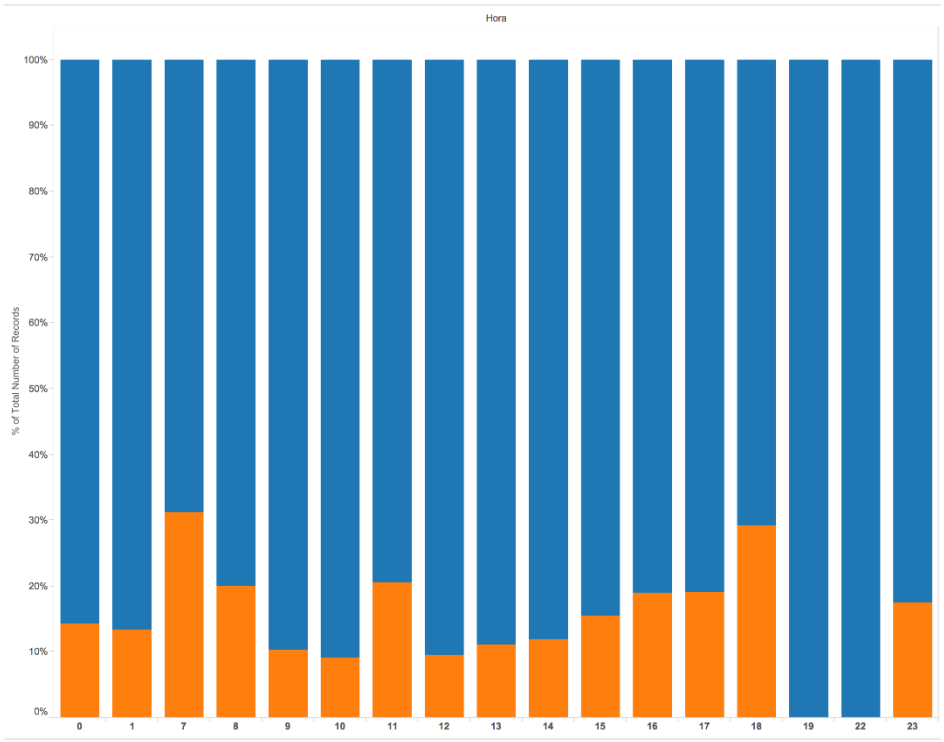
```
  opened           u.open             hora       dia           mes
Mode :logical   Min.   :  0.0000   14     :68849   1:39223   9      :77008
FALSE:257747    1st Qu.:  0.0000   15     :62810   2:12673   12     :37944
TRUE :41911     Median :  0.0000   16     :30494   3:91902   5      :26547
NA's :0         Mean   :  0.2342   13     :28833   4:65559   2      :26544
                3rd Qu.:  0.0000   10     :23914   5:90301   3      :26525
                Max.   :127.0000   9      :18161             4      :26497
                                   (Other):66597             (Other):78593
         dominio       t4.createdBy   t4.largoTexto   t4.largoTitulo
hotmail.com  : 49740   64   :183256   Min.   : 2686   Min.   :12.00
sunat.gob.pe : 32929   65   : 13248   1st Qu.: 3910   1st Qu.:29.00
gmail.com    : 30571   1867 : 25906   Median : 7201   Median :37.00
afip.gob.ar  : 16570   5390 : 13315   Mean   : 7797   Mean   :34.61
seniat.gob.ve: 13218   9798 : 13331   3rd Qu.: 7824   3rd Qu.:41.00
sat.gob.mx   : 12462   11692: 37918   Max.   :33210   Max.   :48.00
(Other)      :144168   11830: 12684
```

Based on the analysis of data you can see how the opening of email behaves in relation to several of the variables:

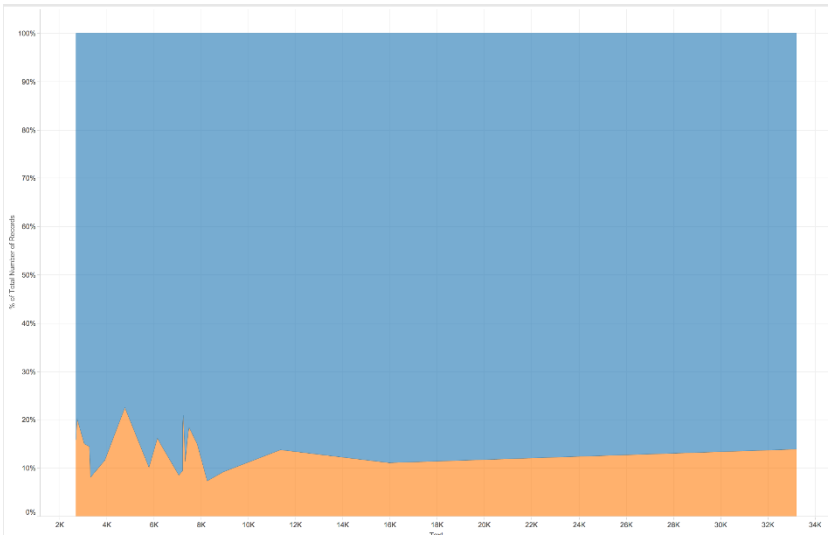


Here we see that mail sent the days Tuesdays and Thursdays have better luck than those sent Mondays.

Then we switch to the chart with the time of sending of the email. We clearly see that mail sent at seven AM have better luck than those sent at 10 AM.



Similar graphs show that the author of the mail has similar influences ranging from about 25% in the best case a little more than 11% at worst.
Finally, the length of the text seems not decisive, since there is no specific tendency.



With this information, we could to imagine that emails should be sent only on Tuesdays, at seven in the morning and with a particular author. However, the possibility of developing an adjusted model allows evaluating the moment more likely, so the majority of emails will be sent at seven in the morning on Tuesdays, but for some users they should be sent at night, others at midday on Friday and some on the weekend. Thanks

the probability to predicting, we know if a mail will be opened with a standard 90% probability of success.

Topic 2.2

THE TAXATION OF HIGH-NET WORTH AND HIGH LEVEL INCOME TAXPAYERS (INDIVIDUALS)

Ximena Amoroso Iñiquez
General Director
Internal Revenue Service
(Ecuador)

Contents: 1. Introduction. 2. Theoretical background 3. Limitations of the tax system. 4. The income inequality in Ecuador. 5. Conclusión.

1. INTRODUCTION

The problem of the taxation of people of high incomes and wealth is a concern in the tax systems, guided by the principle of equity in balance with the revenue adequacy and efficiency.

Prior to the tax issue, it is important to understand, from a conceptual economic viewpoint, the problem that lies behind an inequitable distribution of wealth, which is exposed in the first part of this document.

An important milestone for the countries of the Latin American region is how to use the income tax more effectively as a tool of redistribution of wealth. The document makes a review of the tax policies in the region and shows an emphasis on indirect taxes and the widespread trend to use tax incentives linked to the income tax, which together with a high evasion have resulted in a narrow tax base, weakening its redistributive effectiveness.

The document aims to contribute to the debate on the importance of strengthening the income tax, highlighting its role as an instrument of fairness in the economic system, supporting macroeconomic and social objectives related to the fight against poverty and for social justice.

The second part deals with the Ecuadorian experience, describing the normative changes, highlighting an important milestone, the issue of the reform law for tax equity (2007), which in compliance with the constitutional mandate, acquires for the first time a more important role in the achievement of economic, social and environmental objectives.

In addition to the policy changes undertaken to reinforce the progressivity and the redistributive role of the income tax, the current model of management of the Ecuadorian tax administration provides tax control on individuals with high levels of income and wealth. This demonstrates the progress of Ecuador in examination, implementation of

tools for analysis and, finally, the perspectives and future challenges for the control of this segment of taxpayers.

2. THEORETICAL BACKGROUND

2.1. Why is income inequality negative?

The concept of equality is closely linked to the justice, since in general almost all claim for Justice is actually a demand for equality (Sen, 1992). There are notions of Justice that seem not to promote it or do not seem to mention it, however the quest for equality is a common feature of virtually all approaches to the ethical theories of social order that have endured over time (Sen, 1992). Not only supporters of income equality claim its equal distribution, not only supporters of the welfare call for equal levels of well-being, but the classical utilitarian also insist on an equal weight for each utility unit, for all individuals and even the pure libertarians demand equality with respect to a broad class of rights and freedoms. Although those theories may claim to be "anti-equality" in terms of some variable, it can be demonstrated that they are accompanied by the adoption of equality in another variable (Sen, 1992).

Even the demand for equally satisfying basic needs is a requirement of equality (in a variable in particular), and has been defended for a long time by people who generally are considered "anti-egalitarian". This is related to the concept of individual merit, formulations that makes this idea often involve the notion of “equal merit, equal treatment" giving everyone the same reward for what they deserve. But as you can be seen, usually egalitarianism criticisms tend to become equal in any other variable (Sen, 1992).

Inequalities are generally justified based on analyses in favor or against, probably inevitable and these inequities should be addressed by the principles of social justice (Rawls, 1971). It is not about defining perfect social justice principles, but consider that justice in a society depends on how rights and duties are assigned, of economic opportunities and social conditions of certain sectors of society.

Therefore, if we speak of Justice in a society, we need to focus on its basic structure because it may determine the future of the lives of persons (Rawls, 1971), and because it has different initial positions for each individual. People who are born in heterogeneous social positions have different perspectives of life, on the one hand determined by the political system and on the other by the economic and social circumstances. Institutions in the basic structure of society favor or discourage certain initial positions, determine their inequalities, and these in turn define the initial opportunities for individuals. In this sense, justice, and in particular the distributive justice within this basic structure is a concern of society and there is a responsibility of the State (Bojer, 2003) to ensure it seeks equal opportunities (Sen, 1992).

Justice, as equality of freedoms or capabilities or at the same time as removal of the obvious inequities (Sen, 1992) allows people to lead the life that they reasonably want to carry. You cannot speak of Justice if the basic structure of society is extremely inequitable, because this structure materially affects the prospects of people's lives.

We do not intend, in the name of justice, to ask for absolute equality of income or wealth; these are the only means to achieve other purposes. The ultimate goal is that all people have the freedoms and capabilities (collective not only individual) to achieve their well-being and their goals. We must differentiate the resources that people possess in view of the diversity that characterizes us as human beings, taking into account the differences between people to complete their goals and the importance of various factors that determine the real people's opportunities. The idea is that people should not have neither advantages nor disadvantages to achieve their goals, so that all people should have the same opportunities.

Thus, the most relevant question when defining the society that we want is not the struggle for equality or freedom, what is at stake is rather “what equality” do we want? What is relevant criteria when it comes to judging whether a policy, institution, or allocation of resources is equal and therefore fair? Everything depends on whether the relevant variable has a decisive influence on the basic structure of society.

If the existing conditions in the basic structure of a society make unfair and limiting opportunities of persons and placing them in positions vastly different from other members by the mere fact of being born a specific condition, then the State will have the moral imperative to intervene with unequal treatment to restore the equality of opportunities.

Under this context, wide inequality of income and wealth is a challenge in our times; since in recent decades, in advanced economies, the gap between rich and poor has reached their highest levels. Trends in inequality have been diverse in emerging markets and economies in development; Some Nations have experienced a decrease in inequality, but inequalities prevail in terms of access to education, health and credit, among others (Dabla-Norris, Kochhar, Ricka, Suphaphiohat, and Tsounta, 2015). For these reasons it is not surprising that the increase in inequality and their causes are issues on the political agendas of different countries, since this leads to empirical issues which, in the field of economic, social and public policies, inequalities translates into:

- They affect economic growth in the short and long term. Specifically, if the income of the 20% richest population concentration is increased, the growth of the GDP decreases in the medium term. In contrast, an increase in the income of the poorest 20% concentration is associated with higher GDP growth in the medium term (Dabla-Norris, *et all.,* 2015); this because the middle class and lower class drive most of the growth through interrelated economic, political and social channels.

- They have significant implications in macroeconomic stability, since they can concentrate economic power and political power in the hands of few that built policies at their convenience and in general seek exemptions and tax reductions to reduce their contribution to the State. This in turn leads to use suboptimal human resources, a decrease in the political and economic stability and an increase in risk of crisis. In a theoretical construct Kumhof and Rancière (2010) and Kumhofetall (2012), show that an increase in inequality allows investors increase their financial assets through loans to workers, which financial fragility, results in an increase of the debt/income ratios and thus often lead to a crisis. In particular, studies have argued that a prolonged period of high inequality in advanced economies is associated with the global financial crisis, since they increases the leverage, the over-extension of credit, relaxing the standards of quality of the mortgages (Rajan, 2010) and allows lobbyists to push for financial deregulation (Acemoglu, 2011). An extensive accumulation of the income of the richest accompanied by financial liberalization, which alone can be a policy responsible for the increase in inequality, are associated with substantially high external deficits (Kumhof, Lebarz, Rancière, Richter, and Throckmorton, 2012). These imbalances may challenge the stability of macro-economic and financial, and therefore to growth.

- High social costs. The inequality of results does not generate incentives 'correct', especially if the field is income (Stiglitz, 2012). In this case, individuals have an incentive to divert through efforts to ensure favorable treatment and protection; resulting in a misallocation of resources, corruption, and nepotism with social consequences and adverse economies. In particular, citizens may lose confidence in the institutions, which erodes social cohesion and confidence in the future. Extreme inequality levels could impair the contract and social cohesion, and this is associated with conflicts, which discourage investment. Conflicts are prevalent particularly in the management of common resources where such inequality makes it difficult to resolve disputes (Bardhan, 2005). In general, inequality increase the economic conflicts economy, since it can aggravate the grievances felt by certain groups or reduce the costs of opportunity to initiate or participate in a violent conflict (Lichbach, 1989).

  Inequality has implications of social violence, as shown in several studies on violence and inequality. Daly and Wilson, Vasdev (2001) show that high levels of inequality in the distribution of resources, measured by the Gini coefficient is a major determinant of rates of homicide in Canada and United States. Fajnzylber, Lederman and Loayza (2002) show there are causal relationship between high levels of inequality and higher rates of criminality in several countries. Hsieh and Pugh (1993) found that income inequality and poverty are related to higher rates of homicides and assaults; Gutierrez, Madeleine, Pickett and Wilkinson (2013) performed an analysis coming to conclusion that crime (crimes such as homicide and assaults) increases if the income inequality increases.

- They affect the pace at which growth allows the reduction of poverty (Ravallion, 2004).

  Growth is less efficient in reducing poverty in countries with high levels of initial inequality or, in which the pattern or the distributive growth trend favors the nonpoor. Moreover, as the economies are subject to shocks of various kinds that undermine growth; high levels of inequality make it a major part of the population vulnerable to poverty.

- Inequality may be the sign of a lack of mobility of income and opportunities or, as a reflection of the persistent disadvantages of particular sectors of society. Corak (2013) finds that countries with higher levels of inequality in the distribution of income, tend to have lower levels of intergenerational mobility; since the income of parents go to become an important determinant of income of their children. In addition, it is known that one of the most suitable means of social mobility is education, which is one of the determinants of labor income. An entrenched inequality reduces the educational possibilities and can undermine employment options. It reduces the ability of households with low incomes to stay healthy and accumulate human capital (Galor & Moav, 2004). A low investment of family education lead poor children usually to end up in low-quality schools and therefore they will be less capable of carrying out higher studies. They can decrease the development of skills of individuals whose parents have had low education levels, both in terms of quantity (years of schooling) and, in terms of quality (mastery of skills) (Cingano, 2014).

  As a result, labor productivity will be low compared to other countries that have a more equitable distribution of income (Stiglitz, 2012).

- Reduction of aggregate demand, which could be caused by an increased income concentration, since the rich spend a smaller fraction of their income compared to groups of middle and lower income (Carvalho & Rezai, 2014).

3. LIMITATIONS OF THE TAX SYSTEM

The past decade was accompanied by significant changes in the overall distributional trends. Latin America and Southeast Asia changed the trend towards improvements in the Gini coefficient; while the countries of Europe, China and the United States continued with a growing trend in relation to inequality (Cornia and Martorano, 2012). While Latin America and the Caribbean remains the most unequal region in the world, a promising context on indicators of distribution in the region is configured. The decline in inequality is given by several factors given the variety of national experiences and their specificities.

However, we should not put aside the political context that has accompanied these improvements; regional democracies have been consolidated and in several cases the

political orientations of Governments have favored specific labor and redistributive institutions (Lustig and McLeod, 2009 ;) Cornia, 2010; Robertson, 2012).

In this sense, the majority of States has redistributive goals and can influence in various ways the different levels of inequality in an economy.

From a first point of view, primary income or income arising from the market; over these the State can influence in a redistributive way, for example by setting a minimum wage, monitoring the concentration of goods and services in markets, negotiating between workers and companies. i.e., the distribution resulting from production and market can be modified. From a second point of view, the State can intervene with instruments such as taxes and transfers, re-drawing the distribution - secondary - formed by the market; these mechanisms have direct implications on the distribution of disposable income of households.

Finally, from a third point of view, the redistribution exercise of the State can take place through instruments that can be considered indirect such as for example public spending on health and education. Even if they do not increase the disposable income of people, improve their opportunities promoting the formation of human capital and facilitating the inclusion in the labor market.

The possibility of redistribution by the State through taxes and transfers is of great importance, since it can significantly expand access to resources by households. Despite this, in 17 Latin American countries the Gini coefficient falls just 3% on average, after direct taxes and transfers (Amarante and Jiménez, 2015). The opposite situation occurs in the OECD countries, which after taxes and transfers the Gini coefficient decreases on average 17% (ECLAC/IEF, 2014). The effectiveness of the tax system of the countries varies on the reduction of inequality; but there is the question of why the redistributive effect of the direct fiscal action is so small in our region. The answer to this question comes mainly from three sources, the first two related to the secondary distribution and the latest related to the primary distribution formed by the market:

a. **Problems related to tax policy**, more specifically, the prevailing importance of direct tax value-added tax, taxable small tax income, aliquots casualties of the income tax, and the greater historical importance to income from labor in comparison with the incomes from the capital base.

b. **The disadvantages associated with the management of the tax system:** high levels of evasion and arrears.

c. The problems concerning the economic structure: in particular, the primary distribution of the means of production.

a. Tax policy

a.1. Value added tax versus direct taxation

The changes in the tax systems of Latin America and consequent low power redistribution cannot be understood without understanding its genesis: the so-called “neo-liberal tax policy revolution" which started at the beginning of the 1980s (Jenkins, 1995 and Gomez Sabaini, 2012). The policy was clear: (i) sacrificing the redistributive policy (reduction of rates on income) in exchange for greater efficiency. (ii) Greater horizontal equity. (iii) the clearing of taxes according to the processes of free-market trade and des localization economies to benefit big business; (iv) load establishment of tax value-added (VAT) to compensate for the revenue loss and socialize Prosecutor among all; (v) simplification of the system through elimination of taxes minors and enlargement of the taxable basis.

Since the early 1990s, the VAT was the main protagonist in the increase in tax pressure in the region. Advances in recent decades were the consolidation of the institutional structure of the tax system, supported systemic form in the benefits of the tax value added.

We can mention two properties of the VAT, one technical and one of political economy, which facilitated the increase in the collection of this tax:

I. VAT is a tax that presents a low complexity in tax control, in relation to the income tax. This relative simplicity of control, allowed reducing important and persistent evasion of VAT in recent decades; from the increase of available information systems and control mechanisms.

II. Under neo-liberal policies, it was always easier that funding from the State, via taxes would fall on the shoulders of the large majorities that had no voice or vote in the apparent democracy. They could not access the public opinion to express their so-called freedom of expression, nor were able to react in a timely manner to defend their rights of supervision over the performance of the Corporatist State. On the contrary, with the reduction of the income tax, the benefits of the elites remained unchanged - or in many cases increased. Thus, the VAT was the politically correct tax: it was "he inoculated" to the taxpayer via prices and power groups from coast-to-coast tacitly approved that low social classes would assume the financing of a minimal State, devoid of any social protection function.

Ultimately the advances of the VAT tax system have been important, because a greater tax sufficiency allowed a higher public spending and reduced pressure on the debt. As holistic feature, it must be admitted that VAT, despite its regressive feature, has managed that the State can articulate more spending programs; but at the same time, it generates a phenomenon of fiscal lethargy that we call as "fiscal laziness for redistribution". I.e., the State is usually an important source of resources that have a relatively easy collection, but causes perverse incentives to avoid improving the income tax that is more complex to manage, difficult to control, requires certain political consensus to take transformative reforms. We could draw a parallel with the famous Dutch disease generated by revenues from the exploitation of natural resources, and the fiscal laziness by redistribution that has caused the VAT: Although VAT contributes significantly to State financing, is based on a public spending paid by all in equal proportion, and not gradually. In the same way, it does not limit inequality but that it contributes to the concentration that allow the rich to keep getting richer.

In short, in the neo-liberal "revolution" of taxes since the early 80's, allow a higher collection, which was positive, but it strengthened the unjust distribution of income structures because the tax bill was paid by large majorities, exempting or reducing tax income to the great capitals via tax incentives and reduction of rates. To this, it must be added that after more than 20 years of VAT, countries are reluctant to transform the system in search of greater equity as a direct result of the tax collection performance and simplicity guaranteed by the consumption tax. The "Success" the VAT harvested from the 90s today becomes the biggest obstacle to improve the taxation of income. This success is at the same time the germ that stops to politicians and tax administrations to achieve the optimization of the tax system: that it redistribute income and at the same time raise more resources to finance the Social State.

We must remember that the VAT as the most important tax figure since the early 1990s was conceived in a context of budget cuts and reducing the size of the State. This allowed having a positive fiscal balance at the expense of violating social rights. I.e., collecting the VAT was sufficient for the neo-liberal State at the service of elites. Now the situation is different, many Latin American countries play a new role, the new left governments have managed to advance toward State of social rights, with strong resource requirements that this implies. Therefore, in the long term is not sustainable to have a tax structure of neo-liberal type (minimum) and at the same time maintain a public expenditure according to the socialism of 21st century (Maxima).

VAT is an essential tool in any tax system for its contribution to financial sufficiency. However, the era of the VAT as main source of collection must end. It must be given the role that it deserves: an efficient but unfair collection mechanism. In this sense, a socialist key tax reform must transform the income tax, however, it also needs an effort to design a socially efficient value-added tax, i.e. which minimizes the regressive aspect while keeping its collection power.

A.2. Narrow tax base for the income tax

The narrow tax base in the majority of Latin American countries is given by two main problems: the high percentages of evasion and arrears, and largely by high tax expenditures of the countries. In the Ecuadorian case, the tax expenditure represents 27.18% of total revenue by 2012 (Amarante & Jiménez, 2015).

These high percentages cause the erosion of the tax base and thereby the redistributive effect of direct taxes decrease.

The high occurrence of the expenditure tax in most countries of the region happens mainly under the justification of attracting greater foreign direct investment and promote domestic investment, in order to stimulate the development. Various policies that granted various tax benefits and numerous tax exemptions have surged from this need; However such policies have had few results in the region, not only in an attempt to promote savings and investment but also to achieve a better allocation of investment within individual countries (Gomez Sabaini, Jimenez, & Podesta, 2010).

A.3. Lower aliquots of income tax

The majority of Latin American countries had a process of constant reduction in applied rates of income tax for individuals and legal entities.

The average maximum marginal personal income tax rate declined from 1980 to 2000, from 49.5% to 29.1% and continued down to 27.7 per cent (Amarante & Jiménez, 2015). The rate of tax to legal entities presents a similar evolution, decreasing by 38% since 1980 until 2012 (Jimenez and Lopez, 2012). The contrary fact happened with the VAT tax, which records a growing trend. The Ecuador on the other hand has seen an increase in the top marginal rates and additional taxes on the income tax have been included in recent years.

One of the weaknesses in this sense, both for the region and for the country is that the top marginal rates continue to be low compared with the rest of the world, above all with European countries. The marginal maximum rate of income tax for individuals in Latin America is in the range of 25-35%, while rates of 47.5% and 45% are reached in countries such as Germany and the United Kingdom, respectively. (Amarante & Jiménez, 2015).

A.4. Greater importance to labor income in comparison with the income from capital

One of the peculiarities of the tax income for individuals in Latin America has been its dependence on labor income (Jimenez and Lopez, 2012). The structure of the tax income in many cases has led to these problems. Many countries have tax systems of cedular type that they fail to incorporate all income from capital (which represents a clear inequity with taxpayers who have the same contributive capacity). Likewise, it was not possible to obtain that those who are located in the high-income segment (which are usually those who perceive greater revenue from capital) pay more taxes compared to those who receive less revenue (Barreix and rock, 2007).

Additionally, in most countries, income from capital have a special treatment (a diversity of exemptions and incentives apply) and this has caused that reduce and limit the collection of revenues from capital. This income tax structure reflects an unstable equilibrium; on the one hand, taxed income from work that meet most principles of the tax system and on the other hand, the capital inflows that often fail to comply with the basic principles of Justice present in any tax system.

b. Tax Management: evasion and defaults

A high percentage of tax non-compliance, due to late payment and evasion, constitutes another factor that limits the redistributive capacity of tax income and other direct taxes.

Evasion and late payments cause the violation of two basic principles of tax systems. One is the principle of profit and the other on the principle of capacity to pay, which is composed of horizontal equity and vertical equity. When these problems occur, it is in breach of the horizontal equity (consisting of the equal treatment to those who are in the same circumstances), since taxpayers in equal circumstances may have different tax burdens. Vertical equity is also affected (consisting in unequal treatment to those who are in different circumstances), since individuals with elevated contributive capacities may have greater access to professional advice, which many times are motivating avoidance mechanisms or reduce the risks of non-compliance (Gomez Sabaini, Jimenez, & Podesta, 2010).

One of the main problems for the majority of the countries of the region is the presence of a large informal market. Informality is of vast economic importance, not only because it decreases the number of taxpayers who pay taxes but also because this causes the erosion of the income tax taxable base, and decrease its redistributive power. Integrating this population to the formality must be one of the goals of tax policy for all countries, especially in Latin America where there are high percentages of evasion. In the Ecuadorian case observed significant progress in this regard, it is estimated that evasion decreased from 2001 to 2004 from 51.4% to 44% respectively (Amarante & Jiménez, 2015 ;) Andean & Parra, 2004). These advances are partly a product of new policies

implemented in recent years as the RISE (simplified tax regime), which facilitates the formalization of taxpayers and the decline of late.
To evaluate the vertical equity and horizontal equity two indexes, Kakwani and Atkinson-Plotnick are usually used respectively. The first measures the vertical equity to compare the Lorenz curve of the equivalent household income before taxes with the curve of concentration of the tax (Barreix, Bes, & rock, 2009). The second measure horizontal equity as the area between the Lorenz curve of the distribution of income after taxes and the pre-ordered Lorenz curve consisting of the representation of the concentration of income after tax but sorting taxpayers with respect to their income before taxes (Plotnick, 1981). The redistributive capacity of taxes is also possible to estimate by using the Reynolds-Smolensky index that consists of the comparison of curves the Lorenz before and after taxes.

In the majority of Latin American countries, the income tax for individuals is evaluated; they happen to have a high kakwani index, which means progressive levels. However, because of late payment, exemptions, deductions and preferential treatment to the income from capital, the real rates in the highest levels of income are quite low (Amarante & Jiménez, 2015).

As observed, while the construction of the personal income tax is highly progressive for the majority of countries, their progressive impact is limited due to low levels of collection.

This can be seen in the Reynolds-Smolensky indicator which is quite low, on average 2%, which means that by the action of the tax, only the Gini coefficient is reduced by 2% for 2011 (Amarante & Jiménez, 2015). This indicator is even lower for the Ecuador, in which the redistributive impact of taxation is only 1% for 2011 (Amarante & Jiménez, 2015).

Therefore, the direct taxation in the region in general has a weak redistributive impact and even in some countries, tax systems have come to be regressive; so much for the tax design in favor of capital income, such as tax benefits or greater capacity to avoid tax obligations and high evasion. The high incomes are not taxed according to their level of wealth or income, which causes that sometimes, wealthy individuals pay comparatively less tax than individuals with lower incomes do.

d. Economic structure: primary distribution

As can be seen, the main determinants of the low redistributive effect of tax systems are the predominance of the indirect taxes on consumption and the weakness of the income tax. However, let us not forget that there is a primary distribution, which also restricts redistribution. According to Kalecki (1954), the distribution of income is determined by the relation price/unit cost or the degree of monopoly (a term which summarizes a variety of oligopolistic and monopolistic factors), i.e. the degree of concentration of the means of production. In this sense, Latin America institutions fail to limit (ex-ante) the dynamics of the market that generate the concentration of income and at the same time, these

constraints (ex-post) the redistributive capacity of Governments through taxes and transfers (Amarante & Jiménez, 2015).

The direct income taxes altogether with the taxation on wealth are one of the main tools that Governments have to affect the distribution of income. However, these instruments have been sparingly used in the region.

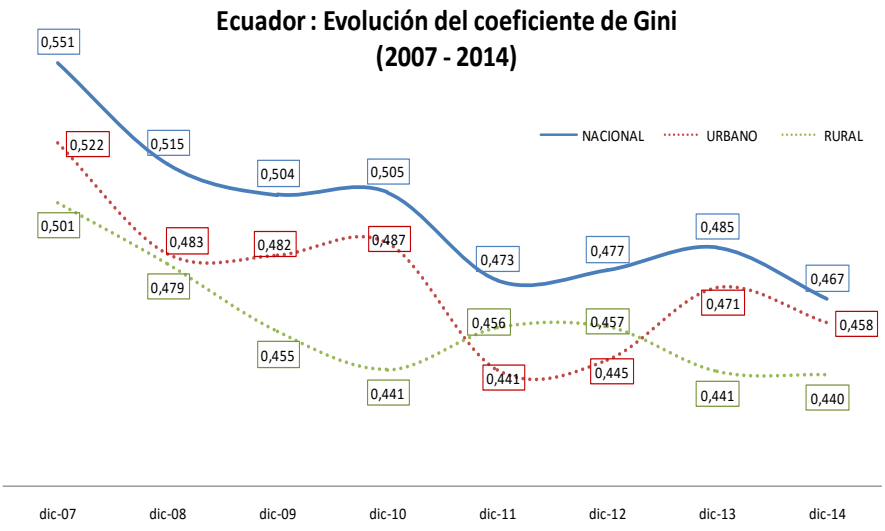
4. THE INCOME INEQUALITY IN ECUADOR

4.1. Evolution of the Gini Coefficient (Period 2007-2014)[1]

Regarding the evolution of the Gini coefficient for the period 2007-2014, Ecuador experienced a sustained decline in income inequality, estimated by the national survey of employment, unemployment and underemployment of the National Institute of statistics and censuses (INEC). This way, the national indicator went from 0.55 in December 2007 to 0.47 in December 2014. This meant a reduction of 0.8 points in seven years. The difference is statistically significant.

The exception of the downward trend was evident in the years 2012 and 2013. Along the same lines, the coefficient for the urban area went from 0.52 in 2007 to 0.46 in 2014, with similar trend to the national coefficient. Similarly, the indicator for the rural area dropped from 0.50 in 2007 to 0.44 in 2014. In contrast to the national and the urban coefficient, the rural Gini presented an upward trend for the years 2011 and 2012.

Graphic 1



[1] Were not considered earlier, since in 2007 has been updated the methodology of the ENEMDU; what hinders comparability.

Source: INEC - Encuesta Nacional de Empleo Desempleo y Subempleo
Creation: Servicio de Rentas Internas.

It should be noted, that in this period, important facts could be attributed to the descent of the Gini coefficient. Increased public spending, living minimum wage adjustment and reform of the income tax of individuals in the tax equity Act, which came into force from 2008. In this law, the tax system was structured with greater progressivity; with the increase of the maximum marginal rate, which rose from 25% to 35%, the modification of the taxable levels, and the inclusion of personal expenses with limit.

4.2. The Tax control of high net worth and high-income taxpayers in Ecuador

Antecedents

The Constitution of the Republic of the Ecuador, existing since 2008, reflects the principles and guidelines of the new social pact, which aims to achieve the *sumak kawsay or good living*. To do so, the Constitution promotes an inclusive economic model, and within this, a tax regime that governed by the principles of generality, progressiveness, efficiency, administrative simplicity, non-retroactivity, equity, transparency and revenue adequacy, prioritizing direct and progressive taxes. These principles tended to reach a tax regime that levels the tax burden among all citizens in a progressive manner, by assigning a greater burden to those who have greater manifestations of wealth.

To give effect to these constitutional principles, objectives and strategies in the medium term have been captured in the *'National Plan of the good living'*. This document contains the roadmap of public policies to be implemented by the Government, and in the tax field, defined as objective, consolidate the social and solidarity economic system in a sustainable way. For this purpose, it is required to strengthen the progressivity and the efficiency of the tax system.

Within this regulatory framework, the tax administration has assumed the challenge of implementing these policies in their planning. So as in the 2012-2015 period, the Internal Revenue Service proposed to increase efficiency and effectiveness in the process of assistance and control, focused on tax compliance, based on a risk management model; and, increasing the application of constitutional principles in tax matters that will help to achieve a more equitable tax system. This lists the main proposals for policy changes and control strategies with which it has tried to capture income tax derived from the revenue earned by the higher economic segments.

General structure

In this context, the internal revenue service structure its control actions depending on the model of management of the tax risks, which aims to define and implement strategies that ensure and encourage the fulfilment of legal regulations.

Control actions are focused on the following elements:

Element	Description
Taxes	Managed by the SRI
Strategic sectors	According to his tax and economic importance.
Relevant segments	Large taxpayers; economic groups and business structures; special taxpayers; and, **owners of capital**.

Source and development: Internal revenue service.

From the understanding of taxes administered by the internal revenue service, the non-compliance with tax obligations by taxpayers is systematically evaluated, analyzed and evaluated (strategic sectors and relevant segments).

From all taxes that make up the Ecuadorian tax regime, the income tax is the most important for the purposes sought by our Constitution of 2008, since it is a direct, progressive tax, levying income obtained, generating wealth redistribution, equity and providing revenue to the State budget. However, prior to the 2007 at the normative level this tax left large segments of income without tax, affecting equity and generality. For example, the passive income from capital had a very lax regime that was located in a more advantageous situation to those who had this type of income than the generality of taxpayers.

This has prompted regulatory reform and improvement of control procedures, especially in relation to the above segments, dividends, inheritance, capital increases, earnings of capital, among other aspects.

In relation to the control income tax from individuals of high levels of income and wealth, the approach is as follows:

Source and development: Internal revenue service.

Ecuadorian experience in terms of control of high net worth and high income individual taxpayers

Dividends

Normative Development

In Ecuador, revenue from dividends, and any type of capital rights are taxable with the tax income. It should be noted that during several periods, the rules that have governed his assessment have been subjected to a series of reforms, as shown below.

When the tax law was issued in 1989, dividends received by individuals and resident companies in the country were exempt from the income tax. They were taxed if the partner who perceived the dividend was another company domiciled abroad, in that case a 36% withholding was operated.

A tax credit on this withholding was granted for the tax paid by the company distributing the dividend.

Subsequently, in 2004, the dividends to individuals and companies resident in the country and abroad were exonerated from the income tax. I.e., members and shareholders of resident companies of the country did not pay income tax.

From 2007, progressive income tax table for individuals was modified, increasing two marginal rates sections of 30% and 35%, but the proportional rate of 25% remained for companies, which generated a problem of equity and double taxation, which was resolved by taxing dividends from the residents of the country in the year 2010. Over time, the cases in which investment is delocalized in the country in order to benefit from the exemptions provided for in the standard were limited, disguising the national investment as foreign investment.

These changes include standards against tax havens, rules against sub capitalization, standards anti-simulation and beneficial owner, among others.

The major reforms that expanded the control over capital income are as follows:

2007 The reform law for the tax equity in the Ecuador[2] establishes that recipients of dividends or profits that are sent abroad will pay the rate of 25% on taxable income, before deduction of the tax credit.

2008 Executive Decree 1051[3] set out in article 130 of the regulation to the law on tax procedure, recognition of 15% of profits paid to workers in a payment certificate, which serves to demonstrate the payment of taxes in Ecuador and use it as a tax credit abroad.

2009 The reform law to the tax law and the tax equity law[4] included as source of income the distribution of dividends, which contributed to reduce a problem of interpretation of the source of tax income.

In addition, article 36 of the tax law provided that dividends and earnings of companies, distributed to individuals resident in the country, will be part of their global income, with the right to tax credit for the tax paid by the company.

2010 Executive No. 374[5] set withholding on dividends taxed when they are distributed in percentages of 1%, 5% and 10%, by setting the maximum withholding when dividends or profits are distributed in to companies domiciled in tax havens or jurisdictions of lower taxation.

It was established that for withholding on the taxable income, the value distributed and the tax paid by the company, corresponding to that distributed value, should be considered.

The case of loans to partners or shareholders presented as distributions was included in the withholding.

Tax credit for dividends in articles 137 and 138 of regulation to the internal tax law were also better regulated.

[2] 3 S.R.O. 242, 29-XII-2007

[3] S.R.O. 337, 15-V-2008

[4] S.R.O. 94, 23-XII-2009

[5] S.R.O. 209, 8-VI-2010. Interestingly, reforms main tax anti-paraiso were set up first in this Executive Decree and subsequently in law.

2010 The organic code of production, trade and investments[6] included standards to close gaps of evasion and avoidance. Thus, for example, the exemption for dividends was canceled for the case in which they were distributed in favor of other companies domiciled in tax havens or jurisdictions of lower taxation.

Moreover, in this code a progressive reduction is granted for three years, from 25% to 22% of corporate income tax and exemptions for several years for investments in priority sectors.

2011 Through Executive Decree No. 732[7], withholdings at source when dividends or profits are distributed were delineated in favor of companies domiciled in tax havens or jurisdictions of lower taxation.

Additionally, the rule of *'tax sparing credit'* was included on income from dividends, internally, recognizing as a tax credit the difference between the tax unpaid by the national society and the tax credit the partner or shareholder who perceived that dividend. The tax credit for shareholders is limited when the benefit is aimed at a tax haven.

2014 The law of incentives for the production and prevention of tax fraud[8], creates a new tax logic to set two rates for companies, 22% in general and by adding 25% for companies which have shareholders in tax havens, or in the case of not reporting to the tax administration.

Additionally the concept of beneficial owner was included, defined as the individual who is at the end of the corporate chain, which improves the control of revenue earned by partners and shareholders.

2014 In Executive Decree No. 539[9] , secondary rules linked to reforms in the law of incentives to production are adjusted. This is about controls and methods of verification of the tax liability as well as the source of the tax, linked to the distribution of dividends, both for people who carry accounting and for those who do not, in accordance with the internal rules.

[6] 2 S.R.O. 351, 29-XII-2010

[7] R.O. 434, 26-IV-2011

[8] R.O. 405, 29-XII-2014

[9] 3 S.R.O. 407, 31-XII-2014.

Control actions

Because the maximum rate of tax on the income of an individual (35%) is greater than the single rate of tax on the income of companies (25%), there is a risk of evasion by moving all the benefits to a society that would pay a lower percentage of income tax.

To mitigate this risk, in the normative scope, starting from the year 2010, dividends are income taxed for individuals. The regulations also foresee the tax credit for the tax paid by the company that corresponds to the received dividends.

In terms of the actions of control, to detect this tax risk, companies that have higher profits in a particular fiscal year are identified massively. This information meets the income tax returns presented by the shareholders of these companies.

When strong inconsistencies are detected, information requirements are sent to companies, requesting from shareholders boards in what consists the distribution of such dividends. Once identified the potential risk, control strategies to apply are defined. For the complex cases, audits are started, or targeted desk audits, which take less time.

Taxation on inheritances, bequests and donations

Normative development

Inheritances, legacies and successions by cause of death are taxed in Ecuador since 1912 by a law that taxed the intestate successions, only since the fourth degree in collateral line. Since that date, there have been several reforms, which can be seen in the annex at the end of this document[i]. Later in 1989, the tax is unified with the income tax, which belongs to the present day.

The last reform occurred in 2007, with which exemptions are established for minors and people with disabilities, reducing by half the percentage of tax to heirs within the first degree of consanguinity. There is also, that the operative event is informing[10] or the Act or contract that transferred the domain and set assumptions to avoid fraud law.

Significant changes in tax income from inheritances, donations and legacies, are currently in discussion with the aim that this is indeed an instrument of redistribution of wealth. In this sense, a more progressive table has been proposed, in which through broader inheritance exemption, the heirs of the lower and middle class of would not pay income tax and the burden of the tax would be heavier on the large inherited estates. Similarly, business start-up are encouraged through reduction of the tax rate, as well as the possibility that the heirs can yield their shares to workers in enterprises, as payment of the tax, so this is a form of capital democratization.

[10] According to the Ecuadorian civil standard, there is a the legal appeal to the heirs (Delación) to accept or repudiate the inheritance left by a person, that occurs at the time of his death

Control actions carried out

The programmed control actions involve identification of heirs, quantification of the estate, and the characterization of avoidance or evasion schemes and estimation of potential revenue.

The purpose of these checks is to establish possible omissions of income statements of taxpayers with high levels of income.

In the implementation of controls, limitations hindering the development of the returns have been detected, as outlined below:

1) Valuation of assets of the deceased taxpayer's overseas.-There is no information of the total assets or with the real value of these assets abroad.
2) Valuation of assets that are in inventory process.-some heirs request inventories, whose result can be obtained after several months or year; i.e. there is no timely information on the value of the assets of each heir.
3) Identification of goods in other parts of the country-there are municipalities that do not have complete information in their registers.
4) Valuation of assets existing at the date of the death of the taxpayer, which have varied at the time of the determination. For example, the information of livestock (cattle) varies in time and tracking is difficult until the date of the control.
5) Identification of goods that are not part of the community property at the time of the death of the taxpayer. Reviewing the assets of a taxpayer, there is property acquired before marriage, which are not part of the conjugal partnership. Taxpayers with high wealth have assets that must be documented, analyzed to define whether they are part or not of the conjugal partnership.

To address these constraints we are working on the following fronts:

- Make agreements with other administrations to have access to information of goods abroad.
- Continue with the signing and execution of agreements for the exchange of information with some municipalities.
- Prior determination processes, a preliminary analysis takes place to identify potential problems in the determination and resolve them, defining the time and scope.
- In addition, legal reforms, which are currently being discussed in Ecuador, have been proposed[11].

[11] In June 2015, the Executive sent to the National Assembly, two projects of reform, dealing with reforms to the tax on inheritances, bequests and donations. However these projects were subsequently removed temporarily

Unjustified enrichment

Rules

The law of internal tax regime in its publication clearly defined that it taxes Ecuadorian and foreign source income. However, the rule that taxes enrichment was not very clear.

In this regard, article 8 paragraph 10 of this regulation defined as income from Ecuadorian source, generic mode a: *"Any other income received by societies and the national or foreign individuals who are resident in Ecuador.*" However this definition went through various periods of legal and judicial interpretation and is currently disused.

Doctrinally, the patrimonial increase is not a net income, but an effect of it, and therefore can come from revenues obtained for consideration - revenues from work, of capital, of business and of raffles and Lotteries for which a compensation is paid - or income free of charge - in cases of succession mortis causa, donations between living and findings.

For this reason, through the reform of December 2014, it was decided to tax wealth increases when these do not can be justified, based on a practical criterion. If economic increases come from unknown sources, at least the respective tax must be collected, for enforcing the principles of equality and generality that govern the taxation. If this increase came from illicit activities, which is shown by the corresponding final decision, the charged amounts are made available to the judge that regulate the matter about their destination.

If they do not come from illegal activities but cannot show their origin, the standard presumes that this income was not declared, and they are treated as such.

The following are the main changes governing the imposition and the increased control of unjustified wealth.

2007 Through the reform law for the tax equity in Ecuador[12], it was established that individuals must submit a statement of their assets.

2010 Regarding the financial statement, the Executive Decree No. 374[13], establishes that it must contain the updated information to January 1 of the following financial year for all individuals whose total assets exceeding 200,000 USD or 400,000 USD in conjugal community property.

[12] 3 S.R.O. 242, 29-XII-2007

[13] S.R.O. 209, 8-VI-2010. Interestingly, reforms main tax anti-havens were set up first in this Executive Decree and subsequently in law.

2014 In Executive Decree No. 539[14] the amounts for the asset declaration are modified, establishing the obligation for: Individuals whose assets exceed the 20 basic fractions Sun ($216,000 to the year 2014); and for conjugal societies or partnerships, when their assets exceed 40 Sun basic fractions ($432.000 to year 2014).

Additionally the equation is set to determine the equity increase unjustified, establishing that if the asset increase is greater than 10 basic fractions Sun go, the taxable person must justify such an increase.

Finally, it is important to note that in 2011 the President of Ecuador, through Executive Decree No. 669, called the Ecuadorian people to a popular consultation and amendment of the Constitution by referendum. This included a question whose text was as follows:

"Do *you agree that the National Assembly, without delay within the time limit laid down in the organic law of the legislative function, starting from the publication of the results of the plebiscite, insert the unjustified enrichment as an autonomous crime in the Criminal Code"?"*

After the elections carried out on May 7, 2011 most voted to criminalize this conduct, which was finally introduced in the Ecuadorian criminal code in article 297, sanctioning the unjustified patrimonial increase greater than two hundred unified basic worker wages in general[15].

Control actions carried out

The principle of progressivity, incorporated into the first paragraph of article 300 of the Constitution of the Republic of the Ecuador force since 2008, says that the tax system will promote, inter alia, the redistribution. This principle is associated with the criterion of capacity to pay, which aims to ensure that taxable persons who enjoy a better economic situation, assume greater tax obligations.

This better economic situation, which implies a greater contributory capacity, reflected in revenues, expenses or investments of the citizens. In this regard, in 2007, he joined in the law on tax procedure, the possibility of starting a process of determining presumptive by unjustified increase of wealth.

[14] 3 S.R.O. 407, 31-XII-2014.

[15] To the year 2015 the unified basic salary of the worker is in general set in the amount of $354,00

A mechanism to track tax evasion in this segment is to compare the income reported in the statement of income tax with the standard of living of the taxpayer or his signs of wealth through the level of spending or investment.

Several Latin American countries apply tests of consistency, comparing revenues with products such as: personal purchases with credit card, rental of real estate, buying and selling before notaries, investments in vehicles or boats, investments in real estate, investments in financial instruments, among others.

These tests are supported by the rule of law and if a discrepancy is detected, the tax administration is entitled to presume taxable income.

Below are the categories of expenses and investments and the amounts that are analyzed for taxpayers that have significant increases in their wealth:

Category	Amount In dollars	Periodicity
Purchases in social clubs	>= 10,000.00	Annual
Purchases in jewelry (*)	>= 10,000.00	Annual
Purchases in travel agencies	>= 10,000.00	Annual
Purchase of vehicles	>= 100,000.00	N/A
Real estate on behalf of the taxpayer	>= 200.000,00	Annual
Deposits and transfers received	>= 100,000.00	Annual
Payments made by credit cards.	>= 100,000.00	Annual

Source and development: Internal revenue service.

To identify taxpayers who have presumably omitted income, requirements of information to third parties are and are verified databases has this Ecuadorian tax administration (vehicles, shopping and sales, real estate, financial transactions, among others).

The analyses carried out has been detected the following limitations that affect the normal process:

- Active on behalf of third parties.-taxpayers put their assets on behalf of family members, companies or third parties in order to hinder the identification of your property.

- Assets located in other countries-there are taxpayers who own property in other countries. In the majority of cases, these assets are located in countries with lower taxation schemes, making it difficult to control tasks.

- Assets and investment trusts-in order to hide the ownership of their property, some taxpayers are commercial trusts. Persons transferring goods, money or rights to an autonomous patrimony, which has legal personality, in favor of third parties in Ecuador (heirs). These goods may remain in the trust for several years; so, in case

of death of the constituent Assembly risk of omitting the payment of the tax to inheritance.

Address these constraints are working on the following fronts:

- The relevance of sign agreements with other tax administrations in order to have access to information of goods abroad is being analyzed.
- Prior issuance of determination processes, is a preliminary analysis to identify potential problems in the determination and resolve them, defining the time and scope.

- It is working on the development of standards to evaluate the variation of wealth and check for unjustified wealth increased.

Sources of information

The internal revenue service has faced several difficulties in the management of information. We can mention:

- Scattered information: The information from taxpayers, received through statements or annexes, was stored in different databases. This situation resulted in delays in their extraction and use.

- Incomplete, limited and unreliable information: The high level of non-compliance in the presentation of statements and attachments, caused limitations to count with all the expected information. Thus, given that the statements are received on paper, there was also a high percentage of error during the process of digitalization of information.

These difficulties in the processing and use of information, caused delays in the implementation of control procedures, require a longer period of analysis and validation of data from the officials.

To resolve these problems, some strategies were developed:

- Consolidation of databases-the tax administration during the past years has incorporated several sources of information to institutional intelligence that come from third parties or from the own taxpayer; as well as tools of information

processing, which have significantly helped in the process of knowledge generation.

- Receive online statements of taxes and annexes.-to have timely information about taxpayers and third parties has been achieved to make information crosses that detect omissions of income, differences in income, costs and expenses which are included in the controls that are carried out at the national level.

- Inclusion of General automatic validators for the reception of information.-have been included logic validation to receive information such as sum, internal references, as well as validation with information previously submitted by the taxpayer and it has unrelated. This mechanism seeks to correction of information before submission.

- Use of computer programs for the management of large volumes of data and constitute an important support in the analysis of the information.

Relevant sources of information

• **Annexes of dividends. -** From the year 2015, taxpayers must submit information related to the generation and distribution of income in respect of dividends, profits or utilities. With this information, you can check:

1) Utilities generated by societies that distribute dividends during the reporting period,
(2) Profit pending distribution generated by companies and
(3) Dividends by companies distributed during the informed period.

This annex it is presented annually in the month of May depending on the ninth digit of the RUC of the taxpayer.

• **Annex of commercial trusts, investment funds and supplementary funds -** in this annex the taxpayers (commercial trusts, investment funds and supplementary funds are public, private or mixed) must submit information concerning administrative, operational and financial movements of these trusts and funds in order to strengthen the control of the proper fulfilment of tax obligations having this information used by these entities.

That annex includes data members, contributions, and benefits of trusts business, investment funds or complementary; information relating to assignments of rights trust; revaluation of assets provided information; information concerning real estate constructions in progress, and information relating to sales, in the case of real estate construction, if any.

This information must be submitted annually, in the month of June of the fiscal year following where appropriate According to the ninth digit of the RUC.

Currently 3,600 taxpayers submit the annex.

• **Annex of notaries, registrars of property and mercantile registrars (ANR)** the notaries, registrars of property and commercial registrars, must report to the tax administration details of transactions on a monthly basis (notaries, registrars of property) or annual (commercial) as appropriate.

• **Statement of assets-** Individuals resident in Ecuador must declare the value of their assets, liabilities and wealth, if their assets on January 1 of each year exceed 20 untaxed basic fractions of the tax income. Those who maintain conjugal partnership or union in fact must file a joint return if their assets exceed 40 untaxed basic fractions of tax income. By the year 2015, the value of assets is USD 216,000 for individuals and USD 432,000 for conjugal partnership. These values are updated annually according to the variation of the Sun basic fractions of tax income.

The information should be submitted in the month of May having, according to the ninth digit of the taxpayer's RUC.

Since the implementation of the annex in the year 2009, the number of taxpayers presenting information from 20,000 to 30,000, with a perspective of annual growth of 10% has increased to 2015.

• **Annex Report of Economic and Financial Operations and Tranaction (ROTEF)-** Financial institutions should report information related to all economic and financial operations and transactions, exceeding USD 5,000. This applies if the transactions are carried out on behalf of their permanent or occasional clients, through any means or mechanism of payment including credit operations, issuance and negotiation of traveler's checks, electronic transactions, transactions through credit cards , debit cards or cards for payment or charge, securities values and other documents that represent payment obligations.

This annex must be submitted on a monthly basis, in the month following the next to appropriate information, depending on the ninth digit of the RUC that the taxable person.

Currently are 76 financial institutions that present the information.

. **Annex to shareholders, participants, partners, managers and members of directorate (annex APS):** Their presentation is mandatory for all society and contains the information of shareholders, participants, partners, Board members and administrators. In the case of shareholders and partners, taxpayers must report the information referred to above until you reach the last stock level, i.e. to identify the national or foreign individual.

Since the implementation of the annex from the year 2012, the number of taxpayers that have 100,000 to 115.0000 information has increased.

. **Agreements for the exchange of information with other institutions of the public sector:** The internal revenue service has agreements for the exchange of information with other entities of the public sector, such as: The Superintendence of companies, securities and insurance provides financial and corporate information of the companies subject to their control. Such information serves as a mechanism for verification of ownership of shares and rights representing capital.

Information exchange agreements with other tax administrations:

The internal revenue service has 15 agreements for the exchange of information with 17 countries. Such agreements are intended to avoid the international double taxation, promote private investment, give protection to taxpayers in the two Contracting States, providing stability in the standard tax, preventing discrimination, facilitate the expansion of companies; and, combating the evasion and avoidance of taxes. The countries that these agreements have been signed are: Canada, Uruguay, Switzerland, Romania, Italy, France, Spain, Mexico, CAN - community Andina, Korea, China, Chile, Brazil, Belgium, Argentina and Germany.

Analysis tools

To process existing information, developed analytical tools that contribute to the optimization of resources in the planning and execution of various control actions to be executed. Such tools:

- **Transactional**: Introduced from the year 2011, it allows the size of the taxpayer, based on revenues, costs and expenses, reported by the taxpayer himself or third parties. This tool is used to perform a preliminary analysis, segment to taxpayers and define the initial control strategies.

- **Taxpayer assets' Matrix:** It is designed to extract the data of taxpayer assets (cash, investments, stocks, shares and rights, receivables, real estate, vehicles and other assets), and to identify possible cases of unjustified wealth increase. It allows segments of taxpayers with high values of assets that were not necessarily high levels of journaling.

- **Risk matrix for control selection:** Using mathematical models based on data mining techniques are analyzed variables such as income, expenditures, economic activity, acquisitions, and controls, shareholding, among others that provide a score that weighs risk, size and revenue. With this result, control actions to apply are defined.

  It is a dynamic model; the results of control actions carried out previously are used for adjustment and calibration of the concerned matrix.

- **Analyst's Notebook - graph of relations**: Displays the stock direct and indirect links between members of an economic group, as well as the final stock level (owners of capital).

IDENTIFICATION OF TAXPAYERS GROUPS

- **Methodology of publicly exposed individuals:** This methodology was created in order to comply with the Forty Recommendations issued by the Financial Action Task on Capital Laundering (FATF), related to the concept of politically exposed persons.

  This concept refers to the individuals who have or have played public roles, such as e.g., Heads of State or of Government, senior politicians, Government, judicial or military senior officials, senior executives of State-owned enterprises, as well as important officials of political parties.

  Currently, a confidential registry is maintained with approximately 390 personalities, with the respective spouses in cases that warrants.

- **Methodology of formation of economic groups:** The establishment of economic groups based on the identification of the Group root, which is the Group of individuals or foreign corporate owners of major rights representing capital of one or more companies. With the system of economic groups, it is possible to identify the shareholding relationships that may have individuals and societies, and analyze if these groups can be classified as economic groups.

  The month of June 2015, there are 125 economic groups in the country, studying 541 people.

Perspectives for control

In the light of the tax reforms of recent years, the development of secondary rules that prop up the rules and processes set out in standard, notably through the efficient management of information is necessary. In this regard, the following regulatory bodies are prepared.

Rules on information of holders of rights representing capital, member of directorates, and administrators.

By resolution No. NAC-DGERCGC11-00393 (official record 567, X 31, 2011), was created the annex to participating shareholders and partners, as a measure to make transparent the activity at the level of the private sector, prevent corruption, improve the tax control and information of holders of rights representing capital abroad, information that the Ecuador didn't have back then.

This resolution was repealed by the resolution No NAC-DGERCGC12-00777 (855, 20-XII-2012 official register) which is in force.

The law of incentives to production and prevention of tax fraud established in article 37 that those societies which fail to comply with their duty to inform on their corporate composition, in the terms laid down in regulation and resolution of the SRI - must pay 25% on taxable income.

In the same sense, the regulation to the law of internal tax regime in the not numbered article after 51, establishes that in the presentation of this information in incomplete form, 25% of the percentage of the uninformed corporate composition will be taxed.

Therefore, a resolution is required, that will integrate the changes set out in the Act and regulations for submission of the annex to information of shareholders, participants and partners, improving additional issues of control and simplification to entities subject to simplified systems of formal duties.

Resolution on financial operations information.

In Ecuador there are rules governing the reserve information and banking secrecy. In general, these rules had there is no secret when there are requirements of the tax administration. However, local financial institutions have been reluctant to comply with these requirements, covered in a series of formal requirements and prior authorizations that rules established and as a result, tax control suffered a severe lack of real access to information.

With this background, in 2014 the monetary and financial organic code was approved[16] in Ecuador, in which his article 353 and 354 eliminates secret for the requirements of the tax administration, which today allows online access to this information.

In this sense, this Administration will regulate the delivery of this type of information through secondary normative acts, according to the regulations.

About capital Gains.

The tax rule not taxed from profits from the occasional alienation of shares until 2014. This meant the assignment of representing capital duties on Ecuadorian companies abroad without the possibility that the State could participate in these utilities. This mechanism was used to transfer the profits generated in a society, not distributed for many years, and recovered by the price of the transfer.

With the law of incentive to the production and prevention of tax fraud (December 2014), was amended tax law, removing the exemption that existed at the date on this type of income. In addition, the calculation formula was established and additional rules that allow the calculation of tribute were delegated to the secondary rules. This rule gravel both

[16] Published in the second supplement of the registry official No. 332 12 September 2014

residents and foreigners who made disposals of rights representing capital. In the latter case, the payment of the tax by the creation of the figure of the substitute to the resident company in the country has been guaranteed and granting the right to repeat for the items charged to this, on dividends owed to the shareholder.

For its part, through the Executive Decree No. 580[17] from the year 2015, the way of calculating the utility in the tax on capital gains from the alienation of shares representative of capital rights was regulated. It has been issued the resolution No. NAC-DGERCGC14-00787[18] in which regulates the percentage of withholding in these cases.

This figure is in full normative development and study by the tax administration. At the same time is pending is issuing normative acts General to regulate the indirect alienation and the percentages of withholding in these cases.

About economic groups

For the formation of economic groupings, will include other factors of relationship between the parties that make up the economic groups, such as the management, administration and business relationship, in order to identify other members, which do not necessarily have equity ties, but that can be considered as related parties.

The analysis of business structures shall be[19], based on the established register of economic groups. This new approach will identify and discuss coordinated actions that maintain several partnerships within economic groups, for example, their tax planning and strategies have been established among them for tax reduction and optimization of results for their shareholders.

The referred analysis will focus on the following aspects:

1. To know the members of the structure and its productive chain.

2. To detect the owners of the capital and how they are related within the structure.

3. To know the behavior of the members of business in the field of tax structure.

[17] Published in the official registry No. 448, February 28, 2015.

[18] Posted in the third supplement of the registry official No. 346, 2 October 2014 and reformed since the law of incentives to the production of December 2014.

[19] A business structure is a productive or commercial chain through which the same process is built on a segmented by a set of related taxpayers

4. To learn about policies and transactions between related parties.

5. To formulate a risk criteria for the process of control.

6. To recommend control actions for the members of the business structure

5. CONCLUSION

The level of inequality of income in the Ecuador has decreased since 2007, from 0.051 to 0.467 in 2014.

This improvement is due to public policy during the period, where tax policy has had a very active role through changes in regulations and tax management, as highlighted in the constitutional mandate.

It is important to highlight the normative changes that have occurred since 2007, which have allowed aligning the tax policy with the economic and public policy, seeking criteria of progressivity and fairness, of pre-eminence of human capital, of prevention of tax fraud and have given to the tax administration better resources for its function of control.

The Tax administration has made important progress in the implementation of controls for the segment of high net worth and high-income individuals, actions that were non-existent until 2007. However, the tools and sources of analysis of information allowing focusing on the actions and progress still need to be strengthened, in the accompanying tax regulation.

ANNEX:

CHRONOLOGY ON THE TAX ON INHERITANCES, BEQUESTS AND SUCCESSIONS IN ECUADOR

1912- The Congress of the Republic of Ecuador, issued the law[1] replacing the Patriotic Tax Act[1].

This Act establishes, among others, a tax on successions, only since the fourth degree in collateral line. A tax is levied on intestates successions exceeding 10,000 sucres, from 2% for relatives in the fourth degree, to 20% for relatives in 10th degree. For the tested succession the tax was half without exceeding 10% if it was collateral heir or 15% for other heirs. Donations were taxed with the same percentages. The spouse, heir or legatee, as well as the heirs and all relatives in grade prior to the fourth collateral line were exempt.

The object of this tax was 'Public education'.

1918.- The Congress of the Republic of Ecuador decreed the law which taxed bequests, trusts[1] and secret or confidential orders[1].

The percentages of this tax are calculated as follows: 2% on appraisals of up to 10,000 sucres, and 5% that exceed this value. Taxable persons from this tax were always legatees. On the other hand, exemptions are created for charities and public institutions. In addition, disciplinary standards for notaries are created in case of not reporting wills containing legacies encumbered with the tax.

The fate of the tax is to increase funds for the construction of school premises.

1920.- The Congress of the Republic of Ecuador, decreed the law establishing the progressive tax on inheritances, bequests and donations[1], which tacitly repealed the previous rules on the matter.

This is the first law that directly creates a tax on inheritances, bequests and donations in our country in a unified way. The tax rate was progressive according to the amount of the succession (not the aliquot of each heir) and depending on the degree of kinship.

The applicable rates were 0.5% for successions in direct line whose value is between 10,000 and 50,000 sucres. Progressivity increased 0.5% to 2% for relatives in collateral line in second, third, fourth, and fifth degree. When the deceased had five or more children, half of the rates applied, and began from 40,000 sucres. Relatives in sixth grade paid progressively from 3%

when the succession did not exceed 20,000 sucres, and reached 10% if it exceeded a million sucres. In case of not being relatives, they pay twice the tax set for collateral in sixth grade. In the case of legatees, the law contemplated to pay tax according to the actual amount of the legacy. The rate was progressive, from 2% when the legacy was worth between 1,000 and 5,000 sucres, and reached 20% when it exceeded a million.

Advance payments were accepted for the tax paid on estates subject to condition or assessment, as in the case of trustees or executors, from 2% to 20% prior to transmission.

1926.- In 1926 taxes for foreigners and the legatees[1] were doubled and exemptions for charities and public institutions were clarified.

1928.- In the Government of Isidro Ayora, was issued the tax Act on inheritance, legacy donations, etc.[1].

This progressive tax with a rate from 1% to ascendants, descendants and spouse receiving between 10.001 and 50,000, up to 26% in the case of collateral and 39% in the case of strangers who will receive more than 2 million sucres. The characteristics were:

-Exemption for small successions.

-Progressive tax in relation to amount and degree of kinship.

-Discounts for dependent children

-Discounts depending on the age of the heirs.

-Precise rules for computing the taxable value of the usufruct, the trust, the use, the room, annuities, etc.

-Rules to avoid international double taxation.

-Power of the Executive to reduce the tax in the case of charitable and public education institutions.

1935.- During the dictatorship of 1935, reforms to the tax on inheritances, bequests and donations, were performed, increasing the assessment. The main progress of this reform is that instead of taxing the succession, it taxed the hereditary share (effective aliquot for each beneficiary).

The tax had a rate for parents, children and spouse: from 1.30% when the value is 0.00 to 10,000 sucres, up to 6% when the value is 1 million thereafter. For collateral relatives the rate depended on the degree of

kinship, it went from 4% (when the value was between 1 to 10,000 sucres) to 40% (when the value is greater than 700,000 sucres). There was a surcharge of 10% on the tax for grandparents and grandchildren, and 20% for other ascendants and descendants. There was also a surcharge for who already has assets or wealth: Singles individuals paid a surcharge of 5% for each 20,000 sucres of equity, while married people paid the surcharge for each 25,000 in case of not having children, and by every 30,000, if they had children.

1986.- During the mandate of Mr. Leon Febres Cordero, the National Congress approved as urgent a draft law describing the Economic Act[1] fixing salaries and living minimum wages and raising salaries and wages of workers in the private sector and of public servants, and tax dispositions for its financing.

This standard created a series of taxes to operations of consumption, as well as duties and fees for public services and State actions. In addition, its Chapter VII established the ' tax law for inheritances, bequests and donations '.

This tax recognized three causing events: the calling of heirs, legacies and other assignments in deed of will, to produce acts or contracts free of payment and, in general, to produce facts or circumstances set out in the Act.

The percentages of the tax applied proportionately according to the following table for the legitimate heirs and spouse, when appropriate:

CUANTIA BASICA SALARIOS MINIMOS VITALES	EXCEDENTE HASTA EN SALARIOS MINIMOS VITALES	PORCENTAJE DE IMPUESTO SOBRE LA CUANTIA BASICA	IMPUESTO SOBRE EL EXCEDENTE (POR CIENTO)
-	10	-	6
10	20	6	7
20	40	7	8
40	70	8	10
70	100	9	12
100	150	10	14
150	250	12	17
250	500	15	20
500	1.000	17	23
1.000	1.500	20	27
1.500	2.000	23	31
2.000	adelante	25	35

Other ascendants and descendants had to pay the tax by adding surcharges that ranged from 10% to 50% depending on the degree of closeness with the deceased, whether these online direct or collateral relatives. In any case, the tax could pass of 60%.

The tax could additionally have a surcharge of 2% for each month of delay in his statement.

This tax contained technical regulations to determine the valuation of assets, in the case of rights of usufruct, use and room, and contained special rules to the vast diversity of regulations in the civilian area of the inheritance law.

1989.- This year of tax law was issued[1], which unifies the tax on inheritances, bequests and donations to the income tax, in a scheme that is preserved until today day. The tax charged for the part exceeding the basic fraction taxed with 0% income tax rate for individuals, with a percentage of 10%.

To be part of the tax income, the same rules of this tax are applied in relation to exemptions and tax base; but elements such as passive subjects, the formal duties, the operative event, the amount of tribute, deductions and tax settlement left to secondary legislation.

2001.- The tax reform law is issued after the dollarization,[1], amending article 36 of the law on tax, reducing the percentage of the tax on inheritances, bequests and donations to the 5%.

In the subsequent encoding of tax law in 2004[1] subsection dealing of inheritances, legacies and donations becomes the section d) article 36.

2007.- The reform law for the tax equity in the Ecuador[1] modifies the section d) of article 36 of the tax procedure law that contains the standard taxing inheritances, bequests and donations.

This reform establishes exemptions for minors and people with disabilities, reducing by half the percentage of tax to heirs within the first degree of consanguinity with the deceased, mentions that the source will be informing or the Act or contract that transferred the domain and set assumptions to avoid fraud law.

Topic 2.2

THE CONTROL OF HIGH NET WORTH TAXPAYERS (INDIVIDUALS)

Martin Ramos
National Tax Superintendent
National Superintendency of Customs And
Tax Administration
(Peru)

Contents: 1. Summary. 2. Context of taxation of individuals. 3. Income concentration in Peru. 4. The Peruvians with high net worth. 5. Failure to declare foreign income. 6. Viability of the tracking of information. 7. Cash flow analysis. 8. Unjustified enrichment. 9. Control of internal and foreign incomes. 10. Exchange of tax information. 11. Conclusions.

1. SUMMARY

This document seeks to explain the control strategy for the segment of individuals with high net worth in Peru, segment that has grown greatly in recent years, due to the continued growth of GDP and the economic expansion that Peru has benefited as a regional investment Center.

The designed control strategy is based on strengthening the capacity of the tax administration, which implies information on investments, improving the sources of information, including the collaboration with other tax administrations through the exchange of tax information and having a specialized team to detect the unreported income.

2. CONTEXT OF TAXATION OF INDIVIDUALS

Taxation in Peru's is of global source, i.e. income from a foreign source are taxed, to the extent that the individual is domiciled in Peru.

From 2009, Peru has adopted a dual model for the income of individuals other than corporate incomes:

- Separation of capital and labor income.
- Implementation of an effective flat rate of 5% for capital income of resident individuals.
- Income from work (independent or dependent) are subject to cumulative progressive rates of 8%, 14%, 17%, 20% and 30%, and foreign source income are added to the income from work.

In capital income, capital gains product of the disposal of securities are taxed, as well as the profit product of the disposal of real estate other than the property used as personal residence.

In addition, gains product of a capital are taxed, such as interest on loans, royalties, as well as revenues resulting from the lease of real estate and movable goods.

On the other hand, dividends are also taxed at a fixed rate of 6.8% for the years 2015-2016, 8% for the years 2017 - 2018 and 9.3% from the year 2019.

It should be noted that national legislation taxes unjustified enrichment, if the taxpayer owns assets which source cannot be justified to the tax administration.

In Peru, there is no wealth tax for the total net worth of an individual taxpayer. There are taxes on certain types of goods, such as the property tax, the vehicle tax or the leisure boat tax.

3. INCOME CONCENTRATION IN PERU

According to a 2012 study by ECLAC (Economic Commission for Latin America and the Caribbean), 10% of the richest households concentrate almost 30% of the national income, which represents an important segment that must be analyzed in terms of their tax compliance.

While the global wealth in Peru is not taxed, the possession of wealth may mean operations taxed for their investments. Generally, a greater volume of assets can be associated with a tax planning that prevents or reduces taxes.

4. THE PERUVIANS WITH HIGH NET WORTH

WealthInsight[1], in its publication "Ultra-HNWIs in Peru to 2013", estimates that in Peru, at the end of the year 2012, there are 23,050 Peruvians who have net assets exceeding $ 1 million, without considering their residence estate. This universe has a wealth of US $111,000 million.

WealthInsight estimates that 39% of the investment portfolio is invested abroad, i.e. US $43 billion dollars and 61% is invested in the local market, i.e. US $ 68 billion dollars. The consultant estimated a growth of 14% for 2017.

[1] WealthInsight is an information center based in England which compiles and analyses data and records of people with assets exceeding $ 1 million around the world, gathering information from private banks and family offices in each country. These figures are approaching the estimates carried out by the Credit Suisse Research Institute in its Global Wealth - Databook 2014.

The net worth of this segment usually comes from the property of companies related to the production and marketing of raw materials and consumer goods, financial services, construction sector. They also benefit from the sale of family businesses to large corporations, which has generated a high liquidity and the need to preserve and grow their assets through the recruitment of financial advisors.

It is important to mention that financial advisors manage a diverse investment portfolio that generates high flows of income from national and foreign source, which must be controlled to mitigate or reduce the risks of non-compliance, increase collection, and improve tax compliance.

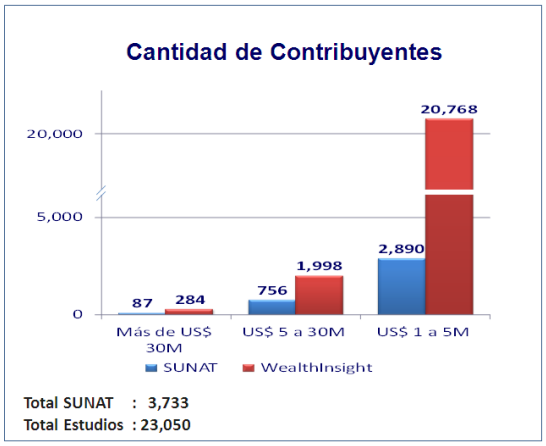
5. FAILURE TO DECLARE FOREIGN INCOME

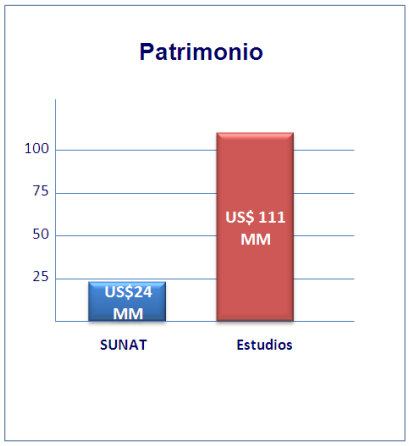
As mentioned above, it is estimated that Peruvians with high net worth would have approximately $43 billion dollars abroad. It should be noted that this estimate is not of income, but of wealth.

The consultant has made an estimate based on nationality, regardless of the residence of the person. However, for purposes of national estimates, if we consider that some of them could be not domiciled in the country, total heritage overseas-domiciled will be close to the $38 billion dollars. This amount - at a conservative rate equivalent to the performance of the Treasury of the EU - (2.187% in 10 years)[2], would be $95 million of foreign source income. The income of foreign source declared in the annual declaration for individuals is $38 million dollars. The gap would be US $57 million.

[2] Source. Investing.com

Identified Peruvians with high net worth





With the sources of information available to SUNAT, 3,733 Peruvians with assets greater than $ 1 million have been found.

Comparing with the figures of the consulting firm WealthInsight, a much lesser amount of Peruvians are identified in the base of the pyramid ($ 1 to 5 M). There is a difference of 17,878 people, so it is necessary to continue improving the sources of information.

Investment preferences

This map shows the preferences of the different segments of wealth regarding investment in assets. It reflects that the millionaires of the bottom segment in Peru ($ 1-5 M) segment have a high propensity to keep their assets in cash and residential properties. The billionaires (more than $1,000 M) and multi-millionaires ($100 to 1, 000 M) prefer business investment (own business), commodities, investment funds, trading, investments off shore, shares, similar to the range of $30 to 100 M millionaires, who prefer equities and investment funds.

It is to note that in all levels of wealth there is a strong preference to fixed income, shares, investment funds, investment offshore. These are precisely the assets that make up the investment portfolio of financial advisors, portfolio that generates high flows of national and foreign source income, which must be controlled to mitigate or reduce the gap of non-compliance, increase revenue and improve tax compliance.

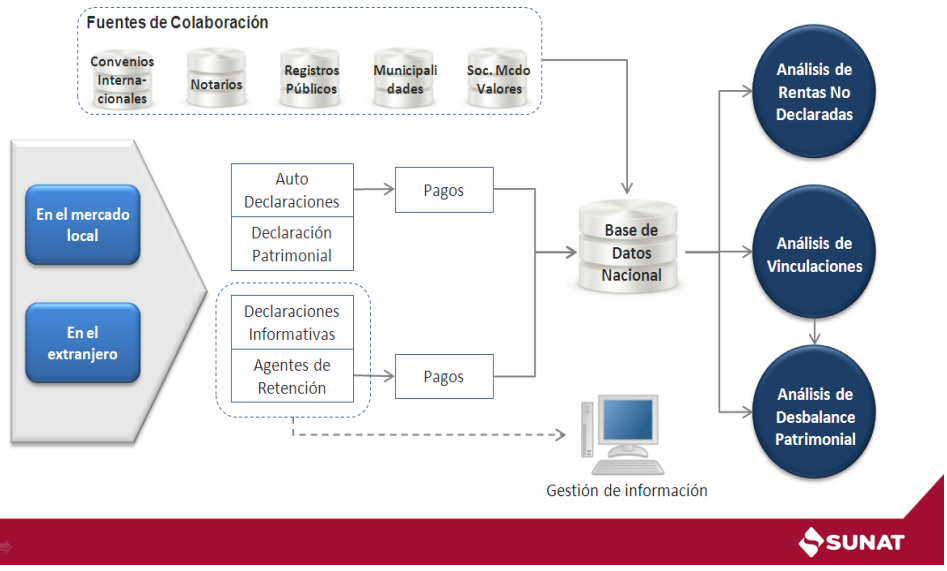
6. VIABILITY OF THE TRACKING OF INFORMATION

According to the consultancy studies, 33% of the wealth is managed by financial advisers, which invest 61% in the local market and 39% abroad.

Financial advisors manage a diverse investment portfolio that generates high flows of income from national and foreign source, which must be controlled to mitigate or reduce the gap of non-compliance. Therefore, investments carried out both in local and foreign markets must be traced.

On the other hand, there are sources of information which help to track investments abroad, financial investments in the country, movement of money through tax on financial transactions (ITF from its acronym in Spanish), as well as control of registrable goods and luxury items.

Control process



The control process seeks to precisely control investments in assets and income (Stocks and cash flows) in the local market and abroad. To do this, very important sources of cooperation are discussed later (institution of clearing and settlement of securities - investment funds). This information is stored in the national data Base in order to carry out a management of information allowing detecting income not declared by the taxpayer and withholding agent, as well as likely assets imbalance, with an analysis of the map of relations in order to detect cases of tax planning.

Within this process of control, the identified universe of high wealth is compelled to present wealth information containing the following basic structure:

- Cash balance.
- Cash balance in Peruvian and foreign banks
- Balance of securities on stock exchange of Lima and foreign stock markets.
- Balance of assets not listed on stock exchange.
- Estates located in the country and abroad.
- Vehicles, boats, ships and aircraft acquired in Peru and abroad.
- Contributions to mutual funds of investment in securities and investment funds.
- Goods delivered in escrow, in Peru and abroad.
- Outstanding credits granted in Peru and abroad.
- Outstanding Credits received in Peru and abroad.

Related information sources

This box is divided into internal sources of information, sources of information coming from the inter-agency collaboration and other unstructured sources resulting from research.

In the first case, you can see the Report of Operations with Third Parties that serves to identify the clients of financial advisors (financial advisors are a small group of companies

grouped in multifamily office, Boutique investment banking, brokerage agents companies, and investment funds) and suppliers of luxury goods customers. The drawback is that information is published annually and the subjects are not stating the complete information. To improve the chance of information and control, these companies will be required to have vouchers and e-books, in order to detect potential flows of Capital income, which allow performing the analysis of likely not justified equity increase.

Another important source is the directory of individuals who are companies' partners, noting that these people are owners of the nation's largest companies that account for 80% of revenue. Something important to note is that many of these companies have foreign companies as shareholders- many of these located in tax havens; therefore, it is convenient to develop a directory of such persons to keep track of those who might be planning with the related companies located in tax havens.

On the other hand, there is the declaration of estates, in which national estates and properties located abroad are declared. This statement indicates the use given to the estates is indicated, for the purposes of crossing the tax information. Additionally, this statement can be crossed with the real estate property public registry, to detect cases of unjustified wealth increase and undeclared cash flows.

It is worth mentioning that the inscription of the property in public records is not constitutive of the right to property, it is only declarative, and the transfer of ownership of a property relies on agreement. The registry protects the purchaser in good faith who acquires an asset from whom appears in the registry as owner, and this is still a weakness that must be addressed.

In addition, the Declaration of leisure boats bring data of the owner and detail of the boat. Notaries provide an important source of information where individual or legal entities carried out transactions on real estate and other goods before reporting them in public records; this is widely accepted in Peru and enable analysis of unjustified wealth increase unjustified and cash flows. In the case of notaries, a software development for online information that will improve control actions is pending with the Notary Union. On the other hand, the monthly movement of the ITF is also another important source to identify undeclared cash flows or cases of unjustified assets increase.

The society of securities market (thereinafter, SMV) will bring information on operations out of the stock exchange marked, as well as from foreign market the taxpayer has to declare in the annual income tax return of individuals.

Another source that will be used for the detection of undeclared foreign source income is the information that can come from the exchange of tax information. The conclusion of memorandums of understanding is pending with other administrations with whom we have agreements to avoid double taxation and TIEAS (Tax Information Exchange Agreements), for defining the fields of information subject to exchange as well as their periodicity.

On the other hand, it is important to expand the network of exchange of information agreements with other administrations, giving priority to countries with higher flow of income and investments, and tax havens used to planning by financial advisors.

In addition, another important source is the research carried out on acquisitions and mergers of Peruvian companies to detect unreported income flows. This is a non-structured information and it can be found in magazines, newspapers, as well as specialized websites.

7. CASH FLOW ANALYSIS

To complement the control process we should perform in addition analysis of the sources of money since it is the reverse to revenues generation. Here, the research begins with the exterior signs of wealth, financial assets; luxury articles, etc., and from there starts the tracing in search of the income that allowed this expenditure.

Income may come from legal or illegal, sources through commercial and financial activities, generating income or profits on behalf of the owner or third parties. They generate, in some cases, networks of related contacts to support complex operations that in many cases hide income or revenue, in the country or abroad, with the intention of avoiding payment of taxes or cover illicit operations.

External signs of wealth give the indications to start the investigation of income, which could determine a non-justified increase in wealth. For this purpose, the analysis of activities is carried out, the value of real estate owned by the taxpayer and family is evaluated, or who pays for the rentals, the value of leisure club memberships, vehicles, boats, luxury stables, the number of servants, trips abroad, social clubs, expenditure on education, and works of art, among others.

8. UNJUSTIFIED ENRICHMENT

In recent years the SUNAT in Peru has been working to strengthen the control of assets increase, so that thanks to the exploitation of information sources we have been able to find deviations of assets, both from licit non-declared activities and illicit activities.

One of the sources that allowed us to detect these inconsistencies has been the tax on financial transactions (ITF), which allows to detect cash movements through the Peruvian financial system. However, it is important to remember that in a country with a high level of informality, much of the economy does not go through the formal financial system, so we have been working in analyzing information from other sources or unstructured information, even more since the cases of money laundering have increased, and crimes such as drug trafficking, smuggling and other activities such as illegal mining have also increased in recent years.

The most common cases detected through the ITF have allowed to find, for example, cases of officials of companies with massive transfers in the country which present inconsistencies since these agents do not declare income obtained abroad and when they enter such capital into the financial system they do not know how to justify the income, despite the fact that many try to justify it through with loans, mortgages, and other figures backed by banks located in tax havens, without better guarantees.

In this sense, the objective of control is focused on three (03) products: origin of funds, economic activity and destination of funds, verifying:

That the origin of the funds and the economic activity of the inconsistencies are supported by directors compensations, incomes from dependent labor, bailouts of mutual funds, etc.

However, when analyzing the destination of funds paid in local bank accounts, money transfers in the local currency (soles) to the account of the companies is checked, whose purpose is to convert soles to dollars since it had a better exchange rate, to be then transferred to a bank account owned by the taxpayer in a foreign bank.

On the bank account of the foreign bank, when analyzing the the destination of the funds, the taxpayers indicate that they corresponded to bonuses granted by the foreign transnational company (of which the peruvian is a subsidiary). However, in general they do not show any document proving the agreements made, criteria and conditions in which they would be granted, nor the approval of the directors of the company. Therefore, the nature of the operation is not clarified, so the tax administration in accordance with the provisions of the income tax law consider such transfers as non-justified enrichment.

Other cases relate to failure to declare the net income of foreign source product of the profits from placements of funds in foreign accounts and investments. In addition, these funds are often moved to off shore companies belonging to the same individual.

In this case it can be observed that individuals, in order to avoid leaving evidence of their movements of funds out of the country, use the companies in which they work to divert their funds abroad, so that the tax administration would not detect other incomes and/or assets or funds in other accounts located in foreign countries.

9. CONTROL OF INTERNAL AND FOREIGN INCOMES

The control of internal and foreign income control rests on three pillars: Control of the financial advisors, implementation of capital income and foreign source income variables and on the exchange of information.

9.1. Control of financial advisors

As mentioned, financial advisors manage a diversified investment portfolio that generates high flows of domestic and foreign source income, which must be controlled to mitigate

or reduce the gap of non-compliance, as well as an opportunity to increase revenue and improving the tax compliance.

It should be noted that to be advised by these companies requires a high surplus of capital (minimum $ 1 million).

Some multifamily office capture investment of $ 10 million as a minimum. In this regard, it is important to identify customers and to capture information on investments in order to control the flow of incomes of high net worth individuals.

On the other hand, **is important to control investment funds** that have been designated as withholding agents by the income tax act. Investment funds are transparent and the participants are taxpayers. Investment funds invest in fixed or variable debt instruments on the local market or overseas, as well as business investment that can generate capital gains upon divestment, dividends or business income.

For the control of investment funds, it is important to identify the participants and receive information on investments in order to control the income flows of high net worth individuals. A low level of compliance with the withholdings statement has been observed, which requires corrective actions in the shortest time.

9.2. Control of capital income and foreign source income

The second pillar is based on the development of variables of capital and foreign source income. This involves incorporating new sources and improve the existing ones in order to detect unreported income.

It should be noted that to achieve efficiency in the strategy a good "information management" is needed, which should be continuously monitored.

There are plans to carry out the selection of cases with the new variables through various inductive channels, making sure that the message to send or action to be performed consider the risk profile of the taxpayer in order to deal with the cases in a personalized way, according to their level of compliance.

While the information of third parties allow more accurate actions, the risk perception of the taxpayer increases, generating a positive impact on the improvement of voluntary compliance when the taxpayer declares his full income.

10. EXCHANGE OF TAX INFORMATION

The third pillar has to do with the of tax information exchange for the control of foreign source income.

Peru currently has a network of agreements that provided for the mode of information exchange, with the following countries: United States of America, Argentina, Chile,

Canada, Brazil, Korea of the South, Mexico, Portugal, Switzerland and countries of the Andean Community of Nations such as Colombia, Ecuador and Bolivia.

The information fields subject to exchange and the periodicity of exchange are to be defined with these countries, through the conclusion of memoranda of understanding. On the other hand, another pending project is to expand the network of exchange agreements, giving priority to countries with greater flow of income and investments, as well as with countries with low income tax rates, which are used in the tax planning.

11. CONCLUSIONS

1. High net worth individuals tend to diversify their risk and the greater the wealth, the greater is the related tax risk and tax planning risk (financial advisors).

2. In Peru, only some assets and properties are taxed, and their record is sparse, therefore SUNAT is introducing tools of tracing with information from various sources (internal and foreign).

3. Traceability will allow identifying undeclared income or unjustified wealth imbalance.

4. To do so, work coordinated through specialized teams (SUNAT and specialized courts) is a priority, because it allow greater control among other things, financial advisors, as well as having greater exchange of information with other tax administrations and national institutions.

To achieve efficiency in the strategy, a good "information management" is needed, which must be continuously monitored and improved to serve as a source for the detection of undeclared income or wealth imbalance.

Topic 2.2

THE TAXATION OF HIGH NET WORTH AND HIGH LEVEL INCOME TAXPAYERS (INDIVIDUALS)

Martine Meunier
High Level Consultant at the Regional Directorate of Paris
Directorate General of Public Finances
(France)

Contents: 1. Summary. 2. Legal framework. 3. Direct taxes imposed to individuals In France. 4. The control of high-income individuals. 5. Particular procedures. 6. Conclusion.

1. SUMMARY

Individual taxpayers with high income or important assets in France are named “High Stakes Cases” (“Dossiers à forts enjeux”, acronym DFE in French). They are subject of a special follow-up since the year 2000.

Confronted with the financial crisis and a chronic budget deficit, France took successive tax measures increasing the tax pressure on individual taxpayers, particularly the high net worth individuals, and has reinforced the fight against tax fraud.

Indeed, the French direct taxes are concentrated on a limited number of individual taxpayers. The income tax is strongly redistributive but also progressive by application of an assessment schedule from 0% to 45 %. An exceptional contribution was added from 2012 for individuals with high incomes (i.e. 250 000 € for an individual living alone); this contribution will be removed when the public deficit will be brought back to zero. These same individuals are also taxed with wealth tax calculated on the higher part of their assets (entry threshold currently fixed at 1,300,000 €) and registration fees for any legal document concerning these assets (in particular transfers, donations and successions).

In addition to the number and amount of these taxes, the complexity of the tax base (exemption, deductions, and imposition by tax household…) incites these individuals to seek strategies of tax optimization to limit the impact of taxation.

In this context, the Directorate-General of Public Finance has adapted by developing specialized control structures for the high income cases in order to implement the political will to carry out a general triennial control with Desk audit for these cases (150 000 cases approximately).

Among the high-profiles cases, there are cases with very high stakes (approximately 5000). Since 2011, these are controlled by a specialized national direction, the national direction of tax situation verification (DNVSF) which enables to have a global vision of the cases and in particular the family groups' shareholders of the large French companies.

The regional directorates of public finances, which are in charge of controlling the other high-income individuals have, or will have a specific structure, « The income/assets control agency » (PCRP). This structure will organize together agents specialized in income and assets with a sufficient expertise to understand a complex case.

A methodology of control has also been implemented (research of internal and/or external information, bringing together the completed returns…) resulting in a financial coherent balance or cash flow balance.

Lastly, additional specific legislative measures for fighting against fraud were voted by the Parliament during these last years.

Indeed, the discovery of a certain number of accounts held abroad by individuals through bank checkups or via the exchanges of information at the European level, as well as information obtained indirectly from HSBC bank in Switzerland, led to reinforcements of the legislative framework. They made possible to tax these non-declared and non-justified assets and to submit spontaneous corrective statements. This last initiative was a great success.

Lastly, like several other countries, France has now a tax police force allowing the implementation of criminal investigative techniques for the most complex fraud cases.

2. LEGAL FRAMEWORK

2.1 Internal law

The general principles of the tax law have their source in the principles of the French revolution stated in the Declaration of the human rights and the citizen (DDHC) of 1789 among which:

The principle of the tax legality

It is based on article 14 of the DDHC: "All the citizens have a right to decide, either personally or by their representatives, as to the necessity of the public contribution; to grant this freely; to know to what uses it is put; and to fix the proportion, the mode of assessment and of collection and the duration of the taxes".

The legislative power, i.e. the Parliament, is consequently the only power allowed to establish or raise new taxes

The principle of equality before the tax

It is based on article 1st of the DDHC: “Men are born and remain free and equal in rights. Social discriminations can be founded only upon general good.”

Nevertheless, a discrimination according to each one's abilities to pay tax is possible as well as a positive discrimination making possible to avoid taxing the citizens most in need.

These principles were included in all the successive constitutions of France.

2.2. International Law

- **European Tax Directives**

The European tax directives have priority over the national law, which must adapt or remove existing contrary provisions.

- **International Tax Conventions**

These conventions aim to avoid the double taxations, fight against fraud and protect the taxpayers.

3. DIRECT TAXES IMPOSED TO INDIVIDUALS IN FRANCE

3.1. Income Tax (IT)

It is a progressive tax established according to the returns filed by the taxpayers (tax household) on the totality of their income obtained during one year. The tax household includes the spouses and the dependent individuals (children mainly).

The number of people constituting the tax household determines a number of parts that makes possible to limit the progressive increase in tax rate by dividing the taxed income by this number of parts.

A progressive schedule is applied, going from 0% to 45 %.

In addition, the methods of calculation include many provisions allowing a personalization of the taxation (divorce, disabilities,…) and many tax deductions aim at supporting certain geographical areas (Overseas Departments and territories - DOM-TOM) or economic sectors (housing, saving energy works, etc.)

The French income tax is redistributive, making possible to reduce by 40 % the income variation between the richest 10 % and the 10 % poorest citizens; at the same time it

remains progressive, including for the very high incomes. In 2014, it has collected 75,389 M€ representing 26 % of the State budget revenue.

In fact, in 2014, 52,5 % of the 37,119,219 taxpayers did not pay an income tax on their 2013 income, a percentage which will increase in 2015 (2014 incomes) with the lowering of the level threshold in the first section of taxation.

The individuals with high income are thus the main taxpayers while benefitting to the maximum of tax deductions incentives.

For the 0.01 % richest, 367 tax households with incomes higher than 5.3 million euros in 2012, the average IT rate reaches 17,6% versus 19,6 % for the richest 1%.

To face the economic crisis and the public deficit, a reinforcement of taxation on the highest incomes has started.

The last tax measures taken in 2012, 2013 and 2014 point in the same direction with a widening of the IT tax base (progressive taxation of the dividends, interests and appreciations) to which is added an exceptional IT contribution due as from 2012 for the individuals with the highest incomes (250, 000 € for a single individual living alone). This tax will be enforced until the tax year during which the public deficit of the public administrations will be brought back to zero. Its amount is 3 % applicable on the tax period of reference ranging between 250,000 € and 500,000 €, and 4 % on the income higher than 500,000 €.

Since 1991, the social generalized security contribution (CSG), supporting the social protection organizations has to be added to the income tax.

This new tax is modern and effective with a broad base, a deduction at source and the application of the proportionality principle.

It provides revenue more than the IT does: 91 M€ in 2013 against 72 for IT.

The complexity and the instability of the legislation now applicable requires a high level of expertise for the control for the high-income taxpayers.

3.2. The solidarity tax on wealth (Isf)

Created in 1982, the tax on high incomes was removed in 1987. In 1989, a new wealth tax, still in force today, was created.

It is a progressive annual tax on the capital, which concerns only individuals (imposition by tax household) having, on January 1, total assets above a threshold of reference (net amount higher than 1,300,000 € since the 1er January 2013).

A progressive schedule by section with a rate going from 0 % to 1.5 % applies to the net amount of the taxable assets.

Several goods are exonerated, of which the professional goods, antique art pieces or collection, authors' artistic or industrial copyrights.

Lastly, an upper limit was established, the purpose of which is to prevent that the total amount constituted by the Wealth Tax and income tax could exceed 75 % of the incomes of the previous year. Any amount above this threshold would reduce the wealth tax to be paid.

In 2014, 331,010 returns were completed (either 0.89 % of the IT taxpayers) which collected 5,198 M€ or approximately 1.8 % of the State tax revenues.

It is thus in fact a rather symbolic tax, which has been removed or is non-existent in the majority of the other countries.

For some opinions, this tax would have in fact a negative output, in particular by causing tax expatriation. In addition, the 100 largest ISF wealth tax taxpayers have an average income six times lower than the 100 largest incomes (the latter benefitting from the exemption under professional goods). For others, the ISF contributes to avoid the deepening of assets inequalities and constitutes an incentive to the optimization of assets by taxing the idle assets.

Moreover, in the current budgetary context, the State cannot remove this source of income in the short term.

The ISF has been added to the registration fees taxing on the changes affecting assets.

3.3. Registration fees

The registration is a formality carried out by a public agent at the time of an act or of a legal fact in particular at the time of the change of a real estate or piece of furniture, a decease, a judicial body etc. The formality of the recording is essentially tax-related; in real estate, there is also the formality of land publicity.

The registration fees indicate the taxes perceived at the time of this procedure.

The registration fees are fixed, proportional or progressive according to the nature of the acts or events.

The main events considered are:

- Transfers subject to payment: sale of a building….

The common rate tax applicable to the sale of a building is 5.09 %.

- Free transfers of property: donation, succession….

The inheritances taxes or estate taxes are calculated on the net share of each heir.

According to the kinship degree between the deceased and the heir, a standard abatement is applied, then a tax by fraction of taxable share.

For the direct heirs, the lump sum deduction is 100,000 € then the rate is progressive, from 5 % to 45 %. Beyond 1,805,677 €, the rate of 45 % applies to the whole of the transmitted inheritance.

The changes on a free basis have collected 10.332M€ to the State in 2014; the changes against payment 934 M€ to the State and 7.757M€ to the local authorities.
Thus, the taxpayers inheriting large assets are strongly taxed during the transmission of their goods.

3.4 Local direct taxes

The local taxes include two distinct taxes: the local property tax, paid by both tenants and owners occupying a residence, and the property tax that is due only by the real estate owner.

These taxes are collected to the benefit of the local communities (regions, departments, municipalities and their groupings).

In 2014, the local property tax collected 20.891 M€ and the land tax 37.335 M€.

Conclusion: the high-income individuals are subject in France to an elevated tax pressure, which has increased during the last years with several measures affecting them directly. Consequently, the search for tax optimization also increased and controls of these individuals has become an essential stake in the fight against tax evasion.

4. THE CONTROL OF HIGH-INCOME INDIVIDUALS

The strong concentration of the budgetary stakes of income tax and wealth tax on a small number of persons justified since 2000, the installation of a specific device founded on an exhaustive triennial control of the DFE, systematically integrating a correlated approach of incomes and assets.

The high-income cases are currently controlled exhaustively every three years. They correspond to the taxpayers whose gross income are higher than 270.000 € (500.000 € if the income corresponds to wages for at least 75%) or if they own assets subject to the wealth tax higher than 3 million euros.

However, the most important individuals presents a degree of complexity making the mission of control difficult for the territorial directorates. Indeed, the taxpayer, in certain cases is with the head of a significant number of legal structures (civil companies, service companies, foundations or trusts…) with varied incomes and with national and international assets exceeding the regional competence of the local directorate.

The Directorate-General of the Finance Public (DGFIP) has implemented, as from 2011 with an organization specific for controlling these high profile cases.

4.1 control of individuals with very high income (DTFE)

Since 1983, a national direction specialized in the control of most complex and most significant cases of individuals, in term of stakes as well as notoriety, exists in France: the national Directorate of Tax Situations Verifications (DNVSF).

The control of the individuals can take two forms: Desk audit or external tax control.

4.1.1 External tax control

An external tax control procedure that is specific to individuals exists; it is the examination of personal tax situation (ESFP). It is a contradictory examination of the situation of an individual taking into consideration tax situation while checking in particular the whole of his or her bank accounts allowing the implementation of a consistency check between the declared incomes, the patrimonial situation, the finances and the elements of lifestyle.

The DNVSF is qualified for the taxpayers whose total taxable income is higher than 762.000€ or whose gross amount of assets subjected to the wealth tax is higher than 6.900.000€ but also for the complex or sensitive files. In 2014, the DNVSF carried out 500 external tax check operations generating 335 M€ of rights and 224 M€ of penalties.

4.1.2 Desk audits

As from 2011, the DNVSF saw its power extended to the field of office control or Desk audit (CSP), including for the wealth tax and registrations fees, in order to become the direction dedicated to the control of individual taxpayers with very high-income

Approximately 5.000 files (either 0,013% of the taxpayers) are attributed to this department according to the importance of the income or assets, representing a gross taxable income higher than 2 million euros or gross assets superior to 15 million euros under the wealth tax.

This organization makes it possible better to know and follow the family groups, and to set up a method of control correlating total income/assets.

In 2014, 1.076 files were controlled within this framework, collecting 90 million euros.

4.1 The Control of Other High-Income Individuals (DFE)

The cases that are not under the responsibility of the DNVSF are controlled by each departmental direction of the Public Finances (DDFIP).

Observing that a partitioned and disparate local organization and increasingly complex cases required new solutions, it was decided to create in each department a structure specialized in the total examination of the income and assets of these taxpayers' files.

This structure, named returns/assets control pool (PCRP) was tested in 2013 and 2014; it is in process of being expanded to all the regional and sub-regional directorates.

To ensure this global vision of the case, the PCRP gathers the agents affected in structures of real estate taxation and those dedicated to book inspections on IT in order to have a global capacity.

PCRP are organized in order to have a global approach of the case, particularly on the declared incomes, appreciations, non-taxed incomes, and the situation in comparison to the wealth tax (ISF). This approach based on the analysis of the returns, acts and on inferences, make possible to analyze the global tax strategy of the taxpayer.

It also makes possible to establish a balance of treasury (incomes/expenses) and/or a control of coherence (incomes/assets) starting from the returns and elements collected in the data-processing applications of the DGFiP (real acquisitions, social participations). It uses the communication laws (with traders, administrations, etc.) and communicate with the taxpayer (request for information or justifications). This control can lead to propose an external control of the individual (ESFP) and/or companies of which he is manager or shareholder.

This organization of the triennial control of high-income cases with a global approach has made more effective to sanction and criminalize the most notable cases.

5. PARTICULAR PROCEDURES

The traditional control techniques do not allow tax authorities to apprehend all the incomes and assets of a taxpayer when incomes are received abroad or on from non-declared life insurance contracts. Recent cases have shown the importance of these assets, leading to a reinforcement of the applicable sanctions, coupled with the possibility of regularizing their tax situation.

Similarly, a tax police force has been created, allowing criminal investigations for fighting the international fraud.

5.1 Taxation of assets held abroad

5.1.1 Consequences of non-disclosing accounts abroad

Individuals domiciled in France must declare the accounts opened, used or closed abroad as well as the references, duration, refunding of life insurance contracts subscribed with insurance organizations established out of France.

In absence of a statement, a fine is applicable.

From January 1, 2013, a simple presumption makes possible to tax at a transfer rate of 60 %, the assets on foreign accounts for life insurance contracts not declared at least once during the last ten years and whose origin is not justified, upon a request of the administration.

The taxation is carried out according to a procedure of automatic assessment.

This exorbitant taxation (since equivalent to the rate of tax on the donations between third parties) applies only to the recalcitrant taxpayers in situation of total denial.

In fact, the objective of fighting against tax evasion must result in ensuring an effective taxation of the hidden incomes and transmissions not declared at the source of these assets abroad except for the situations of statute of limitations or if the operations are not taxable.

This measure was accompanied by the possibility for the taxpayers to regularize their situation spontaneously.

5.1.2 Service processing returns from corrective statements

On September 1, 2013, a service for processing returns from corrective statements (STDR) has been created within the DNVSF allowing taxpayers holding unreported assets to regularize their situation.

The regularization relates to taxes unpaid and not expired from income tax and social contributions since 2006, from the wealth tax since 2007 and the successions or donations since 2007.

The objective is the immediate payment of the due taxes in return for reduced penalties.

The reduced penalties relate to the 40% surcharge for deliberated failure to declare, limited to 15 % for the assets received in the framework of a donation or succession, and the assets owned by the taxpayer when he or she was not a tax resident in France, and at 30 % for other origins.

The regularization concluding with a transaction, no criminal prosecution is carried out, making this provision attractive.

On December 31, 2014, approximately 35.000 files have been submitted.

The cases processed in 2014 have provided an amount of 2M€

5.2 Implementation of a tax criminal police

Unlike in certain comparable states (the United States, Germany, Italy in particular), the agents of the tax authorities were not until now equipped with the powers of a Criminal Investigation Department. The international mobilization following the financial crisis of 2008 to fight against the tax havens gave the opportunity in France to create a tax police force equipped with means of investigation similar to those of the Criminal Investigation Department.

This way, the national brigade of repression of tax crime (bnrdf) has been created to detect and investigate the tax infringements subject to criminal sanctions committed by individuals or legal entities.

It consists of police officers (senior criminal police officers) and agents of the public finances (who become criminal tax officers). It has the powers of a criminal investigation police (sequestrations, searches, police custodies, hearings, requisitions, phone tapping), enforces the criminal law and carries out a judicial enquiry procedure.

The brigade is placed in charge of the tax infringements without notifying the taxpayer when characterized presumptions of a tax infringement result:

- In the use of open accounts or contracts subscribed abroad;
- In the interposition of persons or entities established abroad;
- In the use of a false identity or false documents;
- In the use of a fictitious or artificial domiciliation abroad.

It is from now on a powerful weapon of tax control even if the number of files dealt with by this brigade remains limited.

6. CONCLUSION

The control of the high-income cases is a necessity regarding equity and because of budgetary stakes. However, the use and the existence of non-cooperative states require a constant adaptation of the legal existing tools and structures for a better fight against tax evasion. Within this framework, the installation of an automatic exchange of information in Europe is a step in the right direction in order to put an end to the bank secrecy and the hiding of assets.

Topic 3

TAXATION OF MULTINATIONAL ENTERPRISES INCLUDING ISSUES COVERED BY THE G-20/OECD BEPS INITIATIVE

Andrea Lemgruber
Deputy Division Chief
(International Monetary Fund)

Contents: 1. Introduction. 2. Some numbers may help confirm the argument. 3. Increasing globalization and the relevance of the MNE sector in the world economy have brought the sector's taxation to the forefront of the public debate. 4. The taxation of MNES. 5. Tax administrations and their challenges. 6. A deeper look at the key challenges. 7. Fundamental administrative reforms put in place the building blocks for improved overall tax administrations, including the control of international operations. 8 a specific case may be the need for complementing general TP rules with specific TP rules for some revenue-relevant sectors, such as the NR sector. 9. Conclusion. 10. References.

The control of multinational enterprises: a challenge for developing tax administrations[1]

1. INTRODUCTION

Controlling multinational enterprises (Mnes) is one of the most challenging tasks for a tax administration.

MNEs are, perhaps, the taxpayer type to pose the highest revenue risks in every country. The reasons for ranking MNEs as a risky taxpayer segment seem intuitive: they are the largest taxpayers tax administrations deal with, they operate in a complex and dynamic business environment, they have access to and exploit sophisticated and global tax planning mechanisms, and they have significant influence in the political economy of both developed and developing countries. Furthermore, even though the public and many experts generally refer to MNEs as an homogeneous sector sharing lots of these common characteristics, not all MNEs

[1] Prepared by Andrea Lemgruber, Revenue Administration 2 Deputy Division Chief, Fiscal Affairs Department, IMF, for the 2015 CIAT Technical Conference. The views expressed in this paper are those of the author and do not necessarily represent those of the IMF or IMF policy.

are alike, and some present even higher revenue risks than others due to their global penetration, economic sector, business model, and tax strategies.[2]

2. SOME NUMBERS MAY HELP CONFIRM THE ARGUMENT[3]

- The top 20 MNEs have estimated combined revenue of $4.8 trillion in 2015.[4] Walmart is the largest world company by sales ($486 billion). Only two countries have GDPs larger than the combined revenue of these 20 MNEs: the US ($17.5 trillion) and China ($10.4 trillion). According to Fortune Global 500, the world's 500 largest companies generated $31.2 trillion in revenues and $1.7 trillion in profits in 2014, employing 65 million people worldwide.[5]

- The 2015 PwC report Global on the top 100 companies by market capitalization shows that the aggregate market value of these companies is about $16 trillion. Apple is the number 1 company by this criterion, having a market capitalization of $725 billion (its market cap has increased by almost 8 times since 2009, showing how dynamic the MNE sector is in a changing economy).

- The same PwC report indicates that, out of the top 100 companies, 53 are American, followed by 11 Chinese, 8 British, 6 German, 4 French, 3 Australian, and 3 Swiss.[6] The participation of the US MNEs in the world's largest companies by market share is impressive, and it has increased over the past years (there were 42 American companies on the list in 2009).

- Out of the companies with revenues exceeding $100 billion, over one third are in the oil and gas industry, showing the power of Natural Resource (NR) companies in the world economy—and, of course, the importance of their taxation especially for developing countries, where natural resources are largely

[2] "Global MNEs" are now defined as "companies that operate on a global scale, as opposed to MNEs that are regionally focused. There are various definitions of what constitutes a truly 'global' company, but one way to interpret is a company that has at least 20 percent of its sales in each of at least three different continental markets" (definition by FT.com/lexicon). For tax administrations, global MNEs are typically more difficult to control than a regional MNE due to the greater capillarity and market exposure of their transactions—as well as their large access to tax planning possibilities (e.g. treaty shopping). Besides, tax administrations should use a sectoral approach to understand the specificities of the "large taxpayer" segment (e.g., specific knowledge is required to control the transactions of natural resource companies or financial sector companies).

[3] It is not easy to find consistent and reliable data on the size of MNEs operations and their relative participation and impact in the economy. The bullets in this paragraph summarize different sources and criteria to offer a relative idea of MNEs' activities, participation, and profile.

[4] http://www.statista.com/statistics/263265/top-companies-in-the-world-by-revenue/.

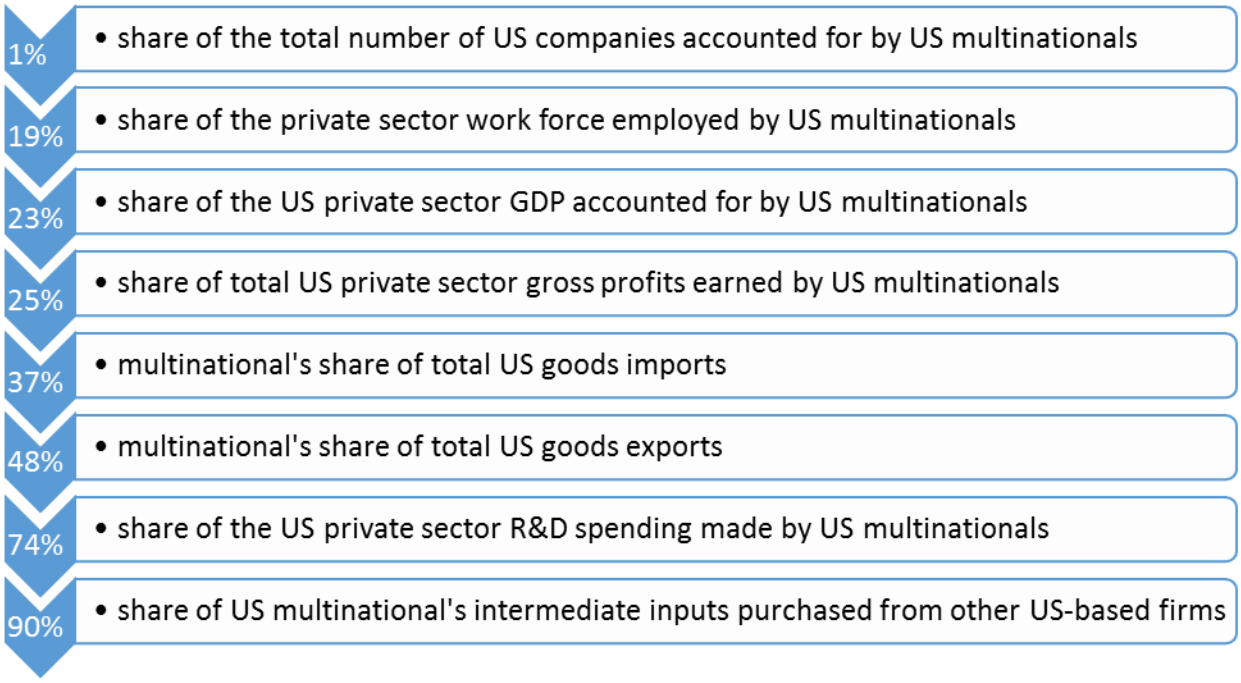
[5] http://fortune.com/global500/

[6] Other countries with companies in the top 100 are: Japan and Spain (2 companies each), and the Netherlands, Taiwan, Korea, Brazil, Canada, Belgium, Ireland, and Denmark (all with 1 company each).

located (a topic that will be explored later in this paper). The other most important sectors are the automotive, conglomerate, and retail.

McKinsey (2010) reports on the role of the US multinationals in the American economy, and their contribution to growth and competitiveness:[7]

Figure 1
An Illustration of the Role of US Multinational Companies in the American Economy



The case of the us illustrates the relative importance of the mne sector even in a highly diversified and advanced economy (see figure 1).

Some key lessons can be drawn from this particular example, which may have general implications for tax administrations across the world**.** Only a small fraction of the US taxpayers: (1) have a significant direct and indirect economic impact (MNEs influence the economic chain in a greater scale—in the American case, 90 percent of US MNEs' intermediate inputs are acquired from other US-based firms); (2) are responsible for withholding wage taxes and contributions of one fifth of the work force; (3) concentrate almost half of the international trade transactions, with clear importance for customs administrations, transfer pricing, and exchange of information; and (4) spend three-fourths of the country's R&D investments, with consequences for the taxation of intangibles.

[7] http://www.mckinsey.com/insights/americas/growth_and_competitiveness_in_us.

3. INCREASING GLOBALIZATION AND THE RELEVANCE OF THE MNE SECTOR IN THE WORLD ECONOMY HAVE BROUGHT THE SECTOR'S TAXATION TO THE FOREFRONT OF THE PUBLIC DEBATE

MNEs have existed for a long time (e.g., the British East India Company), and since those times large enterprises have been correlated, in the public eyes, with great political power, monopoly behavior, and small generation of social benefits—including concerns on labor (e.g., Nike labor disputes) and environmental issues (e.g., Exxon Valdez and BP gulf oil spill). In today's more informed society, issues about MNEs' penetration in the global economy and their taxation—maybe as a proxy for the fairness of their treatment vis-à-vis other businesses and the social benefits generated by their operations—have caught the media's attention and created global awareness about the relatively low level of taxes paid by some MNEs. Some stories have been widely debated in the media, even involving some political discussions questioning the "patriotism" of MNEs.[8]

Against this backdrop, it is important to stress that the current debate on international corporate taxation did not come "out of the blue". The debate is not new and reflects the interplay of many factors, including gradual business and technology advances, as well as the adoption of uncoordinated tax and economic policies across countries over time. Some of these factors are:

- On the business and technology side, the internet has made it possible for companies to do business without a physical presence—a problem for the traditional definition of permanent establishment, which is largely based on the physical presence of labor and/or capital in a source country. The *location of sales* has not been deemed to give taxing rights to the source country. Also, the modernization of the financial system has created so many new instruments that MNEs can "change the source, character, and timing of income with little effort or expense"[9]. For instance, nowadays equity can be more easily converted into debt, which, in conjunction with the traditional allowance for deducting interest spending under the corporate income tax (CIT), may explain the high level of indebtedness of many companies (de Mooij, 2011; Keen and de Mooij, 2012; and IMF, 2014)[10].

- On the policy design side, the architecture of the international tax framework has become so complex and full of exceptions that exploiting cross-country

[8] Arnold and Wilson (2014) summarize the political debate in the US when politicians criticized some American multinationals—including Apple, Amazon, Starbucks, and Google—for relocating profits (or their headquarters) abroad to avoid US taxes. Burger King was called unpatriotic for considering the relocation of its HQ from Florida to Ontario. A similar situation involved Walgreens's plans to relocate to Switzerland. Similar discussions have happened in Europe.

[9] See Arnold and Wilson (2014), pg 1.

[10] IMF (2014) mentions that some telecom companies in Africa are almost entirely debt financed.

tax arbitrage is now part of “doing business” and competing internationally. Examples abound: expansion of tax havens, multiple incentive regimes worldwide, networks of tax treaties leading to treaty shopping (there are over 3,500 bilateral tax treaties in the world), withholding taxes on dividends and interests at zero rates, increasing relevance of intangible assets of various kinds, abusive transfer pricing, deferral of home taxation of business income earned abroad, “inversion” by changing residency, mismatches (when different countries classify the same entity, transaction, or financial instrument differently), and so on.

- On the administrative side, overall weak transparency and poor coordination across tax and customs administrations has also created difficulties to exchange relevant information and implement effective procedures to control transnational operations. Some particular jurisdictions have been traditionally unwilling to share information. Legal frameworks in many countries are out of step with the exigencies of global commerce and its tax implications. Also, administrative procedures are incoherent, insufficient, and non transparent in many countries, which cause weaknesses in the effective control of multinational companies.

- Finally, on the geo-political side, countries tend to balance their interests in promoting the international insertion of their companies with the loss of their tax base—a decision that is influenced by different factors (e.g., whether a country is a capital exporter or importer; size matters as well). For example, some capital exporters exempt active income earned abroad.

The harmful consequences of all these practices on national tax systems are not negligible, even though they are difficult to measure. Arnold and Wilson (2014) identify some key implications that may arise from aggressive international tax avoidance by MNEs: reduces government tax revenues; increases the administrative costs as tax administrations need to ensure that MNEs comply with the tax rules; undermines the perceived integrity of the tax system and may affect overall compliance; undermines fairness of the tax system if other (non-MNEs) taxpayers have to pay a larger share of the tax burden (given that other taxpayers may have lesser access to avoidance opportunities); and distorts location of investment.

In this context, the current OECD/G-20-endorsed initiative on Base Erosion and Profit Shifting (BEPS) is welcome. It advances the international debate on these issues and aims at coordinated action, with the production of specific outputs that intend to address some of the weaknesses of today’s international tax framework. However, the challenges to implement the BEPS package should not be underestimated. The difficulties to control MNEs are significant and the current misaligned incentives to combat BEPS across the globe will not change overnight. Many changes will require implementation through tax treaties and domestic tax legislation—which will demand a broader political consensus even in the countries

that have been participating in the BEPS discussions. Improving the limited capacity of the majority of the tax administrations in developing countries—many of which are not fully engaged in the BEPS debate so far—will require time, resources, and coordinated efforts in capacity building.

This paper intends to shed some light on the current debate by offering the perspective of the IMF base on its long experience in delivering technical assistance to developing countries. The paper focuses on the implementation challenges of the BEPS package and related international taxation agenda, mainly from the administrative standpoint. However, it does not intend to explain and analyze in detail the BEPS outputs. It is also important to stress that the work on the BEPS package is not formally finished at this stage.

4. THE TAXATION OF MNES

Recent studies on the taxation of MNES have found that:

- **Spillovers on international corporate taxation are significant and matters for macroeconomic performance (IMF, 2014)**: Spillovers—i.e., the impact the one jurisdiction's tax rules or practices has on others—can have macro-relevant impact through four main channels: real and financial flows; corporate tax base; tax-setting incentives; and world prices. For example, IMF (2014) argues that FDI flows are impossible to understand without reference to tax considerations. "The potential economic implications of international tax spillovers thus go well beyond tax revenue, with wider implications for the broader level and distribution of welfare across nations." The paper cites that 16 percent of outward investment from Brazil goes to the Cayman Islands. Dharmapala (2014) suggests that more than 42 percent of the net income earned by US majority-owned affiliates is earned in tax havens, while less than 15 percent of their value added is created there.

- **The current international taxation framework is weak and outdated:** IMF (2013, 2014) and OECD (2013) agree that the current international tax rules create opportunities for BEPS due to the exploitation of the gaps and inconsistencies that arise from combining national tax systems. Box 1 summarizes the key problems identified in IMF (2014). Part of the problem is an international tax framework that was built for "bricks-and-mortar" business, operating from a physical presence in a country, with low levels of intangible assets. In other words, the current system is obsolete to deal with companies that are increasingly based on intellectual property assets and operate globally through electronic means. The dynamism of today's economy has changed the business environment very quickly. For instance, Apple, established in 1977, jumped from being company #33 in 2009 to #1 in 2015 in terms of market cap, and is currently #15 in terms of worldwide sales.

- **CIT revenue losses are not negligible and developing countries seem to be disproportionally affected by the distribution of the taxes paid by mnes worldwide**: Experts agree that it is very difficult to estimate revenue losses due to BEPS. Gravelle (2013) estimates revenue losses in order of 0.6 percent of GDP only for the US. Crivelli, de Mooij, and Keen (2015, forthcoming) assess that BEPS and international tax competition do matter for developing countries, at least as much as for advanced economies. The authors' estimates suggest that the long run revenue losses for the OECD economies are in the order of 0.9 percent of GDP while they can be around 1.2 percent of GDP in developing countries.

Box 1
Summary of key messages from "Spillovers in International Corporate Taxation" (IMF, 2014)

- The current international tax framework is based on concepts, such as residence and source, which are becoming increasingly fragile or even meaningless. On the latter, for example, "the increasing disconnect between a company's country of residence and that of its shareholders makes even the relevance of the concept less clear."
- New results confirm that spillover effects on corporate tax bases and rates are significant and sizable. They reflect not just tax impacts on real decisions but also tax avoidance.
- The current balance of taxing rights between residence and source countries (i.e. broadly speaking, developed and developing countries) is felt to result in unfairness. Indeed, "the network of bilateral double taxation treaties based on the OECD model significantly constrain the source country's rights."
- Arrangements that seem unfair may give rise to unilateral domestic actions that can further undermine the coherence of the current tax framework.
- Current legal institutions, such as the bilateral tax treaties, seem to not favor developing countries. For instance, treaty shopping (the use of tax treaty networks to reduce tax payment) is a major issue for many developing countries, which would be well-advised to sign treaties only with *considerable caution*. However, there are currently around 3,000 tax treaties, and increasing numbers of treaties have been signed by non-OECD countries, which are not capital exporters.
- Many developing countries need to be protected against avoidance of tax on capital gains on natural resources by the realization of these gains (transfer of ownership) in low tax jurisdictions.
- Many developing countries also need to be better protected against the avoidance on capital gains on natural resources.

Addressing these problems is not easy and requires a major international effort. The G-20 leaders endorsed an action plan to address BEPS in 2013. After two years, the

initial stage of the work is being concluded, building on a comprehensive effort led by the G20 and the OECD. The aim is to develop a series of proposals of new and improved rules to strengthen the international tax framework. This effort was much needed and it was clear, since the beginning, that no single change could address the problem in isolation.

The BEPS package includes outputs that can be classified in "minimum standards", "common approaches", and "Guidance Based on Best Practices". This approach created a range of measures that reflects their "bindingness range." The BEPS action plan (AP) is structured around 15 key topics (Appendix 1 gives a brief description of the tasks involved for each of the 15 actions):

- Action 1: address the tax challenges of the digital economy;
- Action 2: neutralize the effects of hybrid mismatch arrangements;
- Action 3: strengthen CFC rules;
- Action 4: limit base erosion via interest deductions and other financial payments;
- Action 5: counter harmful tax practices more effectively, taking into account transparency and substance;
- Action 6: prevent treaty abuse;
- Action 7: prevent the artificial avoidance of PE status;
- Action 8: assure that transfer pricing outcomes are in line with value creation: intangibles;
- Action 9: assure that transfer pricing outcomes are in line with value creation: risks and capital;
- Action 10: assure that transfer pricing outcomes are in line with value creation: other high-risk transactions;
- Action 11: establish methodologies to collect and analyze data on BEPS and the actions to address it;
- Action 12: require taxpayers to disclosure their aggressive tax planning arrangements;
- Action 13: re-examine transfer pricing documentation;
- Action 14: make dispute resolution mechanisms more effective; and
- Action 15: develop a multilateral instrument.

Proposals under these categories are in the process of final approval before presentation to the G20 leaders in November, 2015.

5. TAX ADMINISTRATIONS AND THEIR CHALLENGES

Assuming the BEPS package is approved in late 2015, the key challenge moving ahead will be its implementation. Inclusive discussions will need to take place. Recent estimates (Crivelli, de Mooij, and Keen, forthcoming) implying that revenue losses arising from BEPS can be at least as sizable in developing countries as in advanced economies are concerning. Therefore, developing countries' views

should be actively taken into account for the implementation of the BEPS package. It should also be recognized that developing countries are a very heterogeneous group, and different levels of capacity and different concerns need to be taken in consideration. Aspects of the implementation agenda that may be relevant for developing countries should include:

- First, the developing countries that have not been full participants in the process need to assess whether or not to implement the BEPS AP agenda. These countries need to be fully informed and understand the impact of the BEPS agenda for them before being able to take a decision. As an illustration, on issue could be the need to understand the consequences of not being able to implement the minimum standards. This will require, in particular, a wider and deeper discussion on the costs and benefits of implementing the BEPS AP for developing tax administrations.
- Second, the countries that have been involved in the process and others that decide to participate need to discuss *how* this process will take place. This is going to be a gradual process, given that some revisions will require changes in tax treaties and others will demand changes in domestic legislation (e.g., interest deductibility, CFC rules, hybrid mismatches, and Country-by-Country reporting mechanisms). The pace, coherence, and coverage of this process will depend on each sovereign country. Consistency of application is thus a quite significant challenge—and there is a risk of creating an even more uncertain environment as several legal changes occur in parallel across different countries.

- Third, it will be important to clarify *what is included* and *what is not included* in the BEPS AP agenda—and likely consequent impacts for tax administrations. Some administrations, which are nowadays overwhelmed by the complexity of the MNE sector, may tend to think that "life" will be easier and control more effective immediately following their adoption of the BEPS AP. For example; one may think that Country-by-Country reporting would automatically facilitate administration, given that greater and better quality information is paramount to good control. While this measure could bring significant benefits for administrations that have analytical capacity and audit quality already in place, it may have limited effects for low-capacity administrations that are not prepared to use data effectively.

- Fourth, the BEPS package implementation and monitoring may also imply greater use of country resources (e.g., if a sort of peer review is to be put in place); and developing countries will need to balance eventual new demands with the need to keep implementing fundamental reforms given limited budgets and human resources.

- Finally, it will be also important to clarify to the general public that moving the international tax system from pre-BEPS AP to post-BEPS AP will not automatically address all the problems that are currently at the forefront of the public debate. For example, there are problems in international taxation that are

not included in the BEPS agenda (e.g., transfers of interest) and some over-arching issues, such as tax competition, are not expected to be fully addressed.

Tax administrations will have a key role to play if these changes are to succeed—but success is contingent on capacity improvement in some developing countries. The starting point for an improved control of international taxation is leveling up the very heterogeneous administrative capacity around the globe. Even in advanced economies and emerging markets some tax administrations lag behind international good practices. However, in developing countries the knowledge and capacity gaps are wider—particularly in low income countries, where resources are extremely limited. Therefore, the absorption capacity to implement the BEPS AP will likely vary significantly across groups of countries. More work is needed to identify specific challenges for different groups—a task that should be intrinsically connected to the current international efforts in technical assistance and capacity building. This paper calls attention to the challenge of heterogeneity. At this stage, it can be assumed that implementation will be easier for advanced economies and a group of emerging/developing countries whose administrations are modern and effective. However, in practice, the majority of the tax administrations in low income countries—many of which are resource-rich—still struggle to implement basic, routine functions. Managing overall taxpayer compliance is a challenge for these administrations in general, let alone the MNE sector.

The control of an MNE cannot be dissociated from the overall control a tax administration exercises over the universe of taxpayers. If fundamentals are not in place, it is very unlikely a tax administration will effectively control a complex large taxpayer. For example, the IMF's RA-FIT survey[11], which included 86 countries, shows that non-compliance with CIT filing requirements is very common. Only 49 percent of CIT returns and 69 percent of VAT returns were filed on time in 2011. Even though filing compliance is not a significant risk for MNEs, the fact is that tax administrations in developing countries have significant gaps in basic controls. Likewise, some VAT gap estimates are over 50 percent of potential revenue in developing countries, denoting a very poor compliance environment.

The Imf's long experience with technical assistance shows that capacity building takes years to solidify. Many developing countries are still implementing foundational reforms while more targeted reforms on international and NR taxation have been implemented in others. Adapting technical assistance recommendations and technical assistance support to the countries' actual capacities helps maximize the likelihood of success.

- Key tax foundational administration reforms have not been completed yet in some developing countries, even after several years of implementation. To bring things in perspective, country authorities' technical assistance requests continue largely focusing on: elaborating strategic plans and monitoring core performance

[11] See Lemgruber, Masters, and Cleary (2015).

indicators, cleaning up tax registries, ensuring taxpayers file and pay on time, implementing self-assessment, separating headquarters management functions from operational tasks, adopting basic models of risk assessment, introducing electronic returns, adopting collection through banks, and other similar topics. These fundamental reforms continue to be the core priority of the majority of countries in terms of revenue mobilization.

- In parallel, more targeted and sophisticated reforms, including in international tax issues and natural resources, have been pursued as well in some countries. This set of reforms recognizes the revenue importance of a few large taxpayers in some developing countries. Administering these large taxpayers (usually, MNEs) effectively is part of a segmentation and risk management strategy being implemented in many countries. The control of their international transactions is an important aspect of the overall compliance strategy of a tax administration. Box 2 describes the IMF's technical assistance work on international issues.

Box 2
IMF Technical Assistance in International and Natural Resource Taxation[12]

A partial list of country work on international and natural resource taxation includes:

- **Transfer pricing issues:** This work has covered countries as diverse as Bangladesh, Bolivia, Cambodia, Colombia, Dominican Republic, Egypt, El Salvador, Ethiopia, Greece, Guatemala, Malawi, Mongolia, Nicaragua, Panama, and Ukraine.
- **International tax coordination:** Current work being done in East African Community.
- **Provisions of double taxation treaties:** Burkina Faso, Costa Rica, Georgia, Honduras, Indonesia, Mauritania, Nepal, Uganda.
- **Capital gains across borders:** Mongolia and various African countries with natural resources.
- **Holding companies, thin capitalization, and others:** Bangladesh, Georgia, Greece, Malawi, Portugal, Romania, Uganda, Ukraine.
- **Natural resource taxation:** a special Topical Trust Fund was established in 2011 to finance technical assistance in Natural Resource tax policy and administration (as well as public financial management) to low and lower middle income countries. Current beneficiaries of tax-related assistance include: Cameroon, Democratic Republic of Congo, Ghana, Kenya, Lao PDR, Liberia, Mali, Mongolia, Mozambique, Sierra Leone, Solomon Islands, Tanzania, Timor-Leste, and Uganda.

In some cases, tax administration reforms have stalled or failed. This was due to political instability, continuous rotation in management teams, extreme low capacity to absorb technical assistance, external shocks (e.g. military coups and

[12] See IMF (2013).

natural/health disasters), and integrity issues.[13] Without a proper political, managerial, and technical environment, sustaining tax administration reforms is a very difficult task. The implementation of the BEPS AP in low capacity developing countries is sure to face similar challenges.

6. A DEEPER LOOK AT THE KEY CHALLENGES

This paper identifies four key administrative challenges to reforming the current international tax framework. These "umbrella" challenges largely reflect shortcomings and concerns from the overall perspective of developing countries—including those with low capacity where ongoing technical assistance support is being deployed. Some discussions can be nuanced if the focus is the implementation of the BEPS agenda in relatively more advanced tax administrations.

Challenge 1: Ensuring that the administration of international tax operations is embedded in a coherent, sound, and wider design of both policy and procedural issues.

The design of the tax system—in terms of tax policy and administrative procedures—sets the base for good tax administration, including in relation to international taxation. Current systems are plagued by tax incentives and preferential regimes[14], complex tax rules, a network of tax treaties, fragmented administrative practices, and incoherent procedures. The general agreements on the BEPS AP do not guarantee *ex-ante* that major weaknesses of the domestic legislation will be necessarily and fully addressed. The internalization of BEPS AP principles in countries' domestic legislation will demand significant coordination and political will. Changes in the domestic legislation will be needed, involving political choices influenced by various stakeholders and interests: political economy issues will be at play. It should be noted that a set of infra-legal regulations and administrative orders will also be needed to support the internalization of BEPS commitments into domestic legislation. Tax administrations will also need to adapt audit manuals and other internal documentation, and provide for training, IT systems changes, and taxpayer assistance.

[13] IMF (2015) analyzes several "pre-conditions" to good compliance: strengthened and empowered revenue administration headquarters, adequate and stable financing, sufficient autonomy, integrity, focus, and streamlined and clear structures.

[14] OECD (2014) mentions that "…while tax incentives for investments are a challenge for most developing countries, fragile states are particularly vulnerable to agreeing unfavorable terms. This is because in fragile states the need to generate any revenue quickly is often coupled with particularly low tax policy and administrative capacity. As a consequence, they grant excessive tax exemptions to powerful multinational corporations, often in the natural resources sector and potentially in violation of their own domestic laws."

Some examples of challenges to be addressed in developing countries are:

- Complexity arising from exceptional regimes, such as stability clauses for large NR companies: Stability clauses often cause problems for tax administrations. Calder (2014) argues that "their scope, including conditions for review, is sometimes unclear. They may present an obstacle to much needed legislative reform to simplify and consolidate rules applying to different companies or to strengthen weak legislative provisions." Stability clauses are the product of legal uncertainty and political instability, so common in low income countries, but also may, in practice, prevent these countries to make changes to strengthen their systems over time. In particular, developing countries should ensure that stability clauses are not "extended to reasonable changes to laws, regulations, and rulings on administrative compliance intended to improve the tax system or prevent abuse" (e.g. strengthening of transfer pricing legislation). This will be a key point at a moment when some of the TP framework is being revised.

- Complexity arising from the network of treaties: such a network implies administering "different" regimes with different clauses and tax rates, in addition to the risk of losing revenue to treaty shopping. Revising this network will not be a simple task for developing countries. Moving ahead, IMF (2014) recommends that extreme caution should be exercised by developing countries when signing tax treaties—actually not for administrative issues only, but because treaties have not been, in general, to their benefit. If they do sign new treaties or revise current ones, it will be important to build in protection against treaty shopping, even though this may imply additional burden to tax administrations.

- Weak and incoherent legal administrative frameworks: The control of MNEs and their complex international transactions should be based on legal, sound, and transparent administrative procedures. However, in many developing countries there is no robust tax procedures code, and it is common to observe weak and unclear procedures, which sometimes are applied differently to MNEs. For example, some countries subject a whole MNE sector (e.g. natural resources) to different rules that depart from the normal tax procedures, such as: agreements that only require accounts to be prepared rather than formal tax returns; different payment rules; different rules for interest on late payment and penalties; and different rules for dispute resolution. This is unnecessary and non-transparent, and complicates control. Considerable work will be required on the legal administrative front to set the basis for good tax administration in developing countries. This "layer" of work, for example, is not an issue for developed administrations.

Challenge 2: Implementing the BEPS agenda in a sustainable and sequenced way that is supportive of ongoing foundational tax administration reforms in developing countries.

7. Fundamental administrative reforms put in place the building blocks for improved overall tax administrations, including the control of international operations. These reforms are ongoing in many countries but it will take years for some of them to close the gap and build enough capacity to effectively administer MNEs—in particular in the areas of audit and dispute resolution.

- Even advanced economies struggle to train and retain good auditors who are able to cope with the demands of sophisticated international transactions and financial instruments. But in environments where basic tax administration functions (registration, filing, and payment) lag behind, audit is typically "non-existent" in practice. In many low income countries, audit departments are small (less than 15 auditors), skills are very limited (in some places, about 50 percent of the workforce do not have college degree), audit manuals are not in place, and tax returns are manual. Recent IMF missions have confirmed that the audit program in these countries is restricted to reviewing internal inconsistencies of paper-based tax returns, without the support of third-party reporting. Under these circumstances, auditing transfer prices has very limited effectiveness. It is not clear how the BEPS package will facilitate control for these countries. For instance, moving ahead, further simplification of—and more objective—transfer pricing rules will likely be needed.

- Domestic dispute resolution systems lack effectiveness in many developing countries. In some cases, at the administrative level, the same auditor (or audit unit) is responsible for reviewing the taxpayers' objections. The judicial system is often weak and perceived as non-transparent. The complexity and loopholes of the tax laws, combined with low audit capacity and unskilled judges, have led tax administrations to often lose many international tax cases in developing countries. One of the current key challenges faced by tax administrations is to assess the costs and benefits of engaging in lengthy and complex audits if the majority of cases fail in the end. The development of a robust, independent, and tiered appeals system is part of the overall maturation of a tax administration system, and needs to be in place if complex cases on international taxation are to be effectively addressed.[15]

[15] On a separate point, the BEPS outputs include the development of solutions to address obstacles that prevent countries from solving treaty-related disputes under Mutual Agreement Procedures (including the absence of arbitration provisions in most treaties). Whether these alternative mechanisms would improve the positions of developing countries in such disputes should be evaluated.

If countries feel the pressure to implement the BEPS agenda quickly (E.G. Audit Transfer Pricing), there is a risk that partial or short-term solutions are taken—which may not be of the best interest of the tax authorities to consolidate long-term capacity. For example, outsourcing of the audit function to private consulting firms has been used to make up for the lack of audit capacity in some resource-rich countries (e.g., in some African countries). A thorough assessment of the viability of this solution in the long term should be done. On one hand, outsourcing helps to immediately secure revenues in low capacity environments. However, many of the MNE investments are long term, and if knowledge is not transferred, the administration will not build capacity over time. Also, issues of conflict of interests need to be taken into consideration. These trade-offs are not easy and should be discussed.

Addressing these challenges will require a comprehensive and medium-term technical assistance (TA) engagement that:

- Goes beyond "international issues" and focuses on strengthening the overall tax administration because the compliance control of an MNE cannot be dissociated from the overall control a tax administration exercises over the universe of taxpayers.

Figure 2 depicts an illustrative distribution of taxpayers as a function of their size and global penetration. The majority of the taxpayers (about 70-80 percent) are small and local, some are medium-sized with some international operations, but just a few are large…international…and global. While it may sound counterintuitive, the control of international and national companies is closely related. A good example was shown for the US case, where MNEs operate as key "buyers" in the economy, feeding the whole economic chain. In some countries, large companies even are given the responsibility to withhold small companies' taxes. The control of international and national transactions of an MNE is closely related too. MNEs are also major local producers, importers, and exporters, implying that they have large VAT operations that may also lead to sizable VAT refund claims.[16] They are large employers that withhold taxes and social contributions of their employees. Figure 3 depicts the participation of different tax bases for low-income countries, and MNEs play a key role as payers in all these categories (note the relative high importance of consumption and trade taxes in these economies). Furthermore, domestic TP is a particularly important issue if businesses can explore tax arbitrage opportunities created by tax holidays. Therefore, "domestic" and "international" are closely related and tax administrations should not lose sight of managing overall taxpayer compliance.

[16] In particular in the NR sector, where the majority of the production is exported at zero rate, and imports of large capital goods is a norm, VAT refunds have become "the" issue in many countries—with large outstanding refund claims that may reach 2 or 3 percent of GDP.

Figure 2
Distribution of Taxpayers by Size and International Exposure (Illustrative)

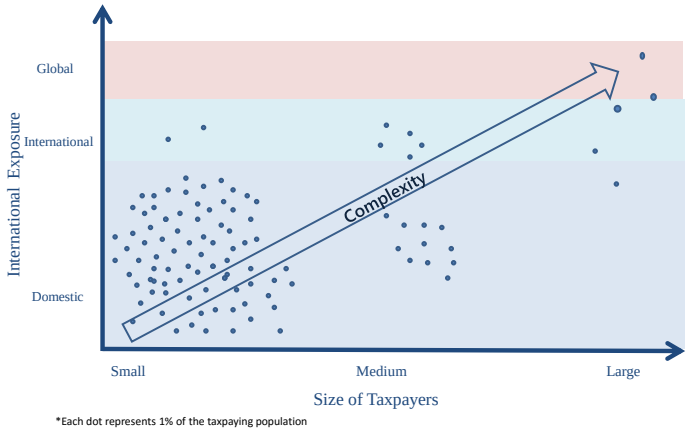
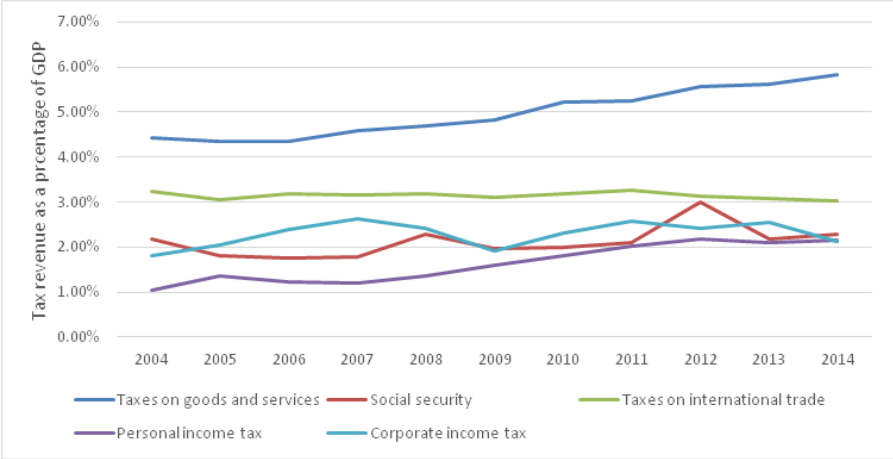


Figure 3
Revenue Distribution by Major Tax Categories in Low Income Countries



Source: IMF/WEO

- Develops analytical capacity that underlies good quality tax administration because it is impossible to control large taxpayers without robust information and the use of analytics.

Exchange of Information (EOI) is at the heart of an improved international tax control, but its effective implementation is not simple for developing countries. EOI is as good as the quality of the information, which depends on sound IT systems, e-government solutions, reporting mechanisms, taxpayer assistance, and capacity for data analysis. Four key issues make the effective EOI more difficult in practice for some

developing countries: (1) the poor quality of information (many developing countries lack integrated and robust IT systems, tax return forms are ill-designed, and taxpayers' information is reported manually, even for large taxpayers); (2) the limited use of information for tax control (many administrations are not prepared to use third-party information effectively as an input to support the audit work, and even revenue authorities do not properly exchange internal tax and customs information); (3) the weak confidentially of information (increasing flows of sensitive information need to be safely protected, which is a challenge in environments where IT systems lag behind); and (4) the lack of completeness of information (if relevant information is not accessed, partial information may not be enough to exercise effective control[17]).

- Builds capacity in international taxation in a gradual but sustainable way, being supportive of ongoing capacity building efforts.

The BEPS AP implementation should create momentum to encourage long-lasting tax reforms, and avoid draining resources that are needed to finance the overall improvement of tax administrations. In managing limited budgets, weak capacity, and competing resources, tax authorities will need to find a way to balance priorities. Coordination between donors and TA providers—a task that has been improving but it is still very challenging—will be even more important to ensure that efforts are not duplicated. Without putting in place the "building blocks" of a good tax administration, sustainable and effective BEPS AP implementation may be limited in low income environments. Proposals such as the development of 'toolkits' (whose precise meaning remains somewhat unclear), and training can be useful. However, these "outputs" alone cannot ensure that the desired "outcome" (i.e. actual transfer of knowledge) will happen effectively.[18] On this, IMF (2014) states that "Important though it is for developing countries to cope better with the challenges of international taxation, this should not distract from wider and more fundamental tax reform objectives."

[17] Tax havens and other low tax jurisdictions have been changing behavior in recent years due to the efforts of the international community, but the work is far from complete. Bilicka and Fuest (2014) find that tax havens have systematically signed more TIEAs with countries to which they have stronger economic relations in the form of FDIs, which is very positive. But the paper highlights that "…however, an important caveat is that this does not mean treaties for information exchange cover all relevant countries. On average tax havens only have treaties with roughly half of their five most important economic partner countries. This means that the network of treaties for information exchange is far from complete."

[18] This is a problem faced by TA providers nowadays: ensuring that permanent outcomes are reached, with impact on the ground, is different from delivering TA outputs (e.g. reports, presentations, workshops). The practical experience shows that more is needed in the field of capacity building and hands-on support is required for a long and sustained period. Over the past 5 years, the IMF's technical assistance, with the support of key international donors, has moved towards greater medium-term engagement (3 to 5 year projects) and an enhanced focus on Results-Based Management is being adopted.

Challenge 3: Initiating an inclusive discussion on specific issues and circumstances faced by developing countries in order to facilitate a more effective absorption of the BEPS outputs in low capacity environments.

As the BEPS AP Implementation widens, it will provide an excellent opportunity to discuss specific issues and challenges that may apply to developing countries in particular. Some of the discussions may involve, for example, (1) initiatives to help countries assess their overall tax systems and formulate wider tax reform priorities; (2) the development of an appropriate institutional structure for an inclusive discussion of international tax issues; and (3) the need for more objective and/or specific transfer pricing rules.

A deeper understanding of the current gaps developing countries face to mobilize revenue underlies any successful tax reform, including in international issues. A recent joint IMF/World Bank initiative aims at supporting revenue mobilization in developing countries. "Responding to country demands, the IMF/World Bank initiative has two pillars: deepening the dialogue with developing countries on international tax issues, aiming to help increase their voice in the international debate on tax rules and cooperation; and developing improved diagnostic tools to help member countries evaluate and strengthen their tax policies. This builds on the Bank's current tax programs in over 48 developing countries and the Fund's tax related technical assistance projects in over 120 countries."[19]

Developing countries may face greater difficulties to protect and expand their corporate tax bases in the face of challenges in applying the arm's length principle (ALP). Following conventional CIT practice, the ALP is self-assessed, taxpayers have to document that their internal TP correspond to arm's length prices, and tax authorities can challenge this. However, it is a common view that the practical application of these rules is too complex, costly, and permissive—even for advanced tax administrations. The result is that profits have been allocated to low tax jurisdictions. IMF (2014) argues that the compliance and administrative burden of the application of ALP is substantial; and the situation tends to increase "as business become more knowledge-intensive and technology-driven, management becomes more geographically diffuse, and intra-group operations become easier to transfer and more difficult to price." The challenges in ALP for developing countries include geographical adjustments[20], location savings, non-competitive business arrangements, asymmetric approaches, and risk transfer. Against this background, IMF (2014) suggests discussing a specific agenda for addressing TP challenges in developing countries, based on four pillars: introducing appropriate anti-avoidance rules, developing more detailed guidance on how the ALP should be applied in

[19] http://www.imf.org/external/np/sec/pr/2015/pr15330.htm

[20] In the absence of public data on market transactions in developing countries, taxpayers will resort to foreign operations in advanced economies to price their controlled transactions. In practice, market prices in advanced economies may not be directly applicable to low income countries, and there is no guidance on how to adjust for different market structures, appropriate interest rates, and different country risks.

concrete situations that concern developing countries very specifically, improving public data availability for comparability studies, and capacity building.

A specific case may be the need for complementing general tp rules[21] with specific tp rules for some revenue-relevant sectors, such as the NR sector.[22]

Calder (2014), and Lemgruber and Shelton (2014), show that the NR sector has very particular characteristics: non-renewability, varied scale and profitability, exceptional rent-generating potential, high uncertainty and risk, substantial capital investment, long development and operating periods, geographic concentration, and high levels of imports and exports. Such characteristics lead tax administrations to face challenges to manage departures from standard tax legislation, including special taxes (e.g. royalties, progressive or rent-based taxes and bonuses); specially negotiated contract-based tax regimes; and particular NR-related tax provisions (e.g., benchmark-based pricing, ring-fencing, cost recovery limits, deduction of abandonment of reserves, and investment incentives). Administrations also need to deal with variations in fiscal terminology and apply taxes subject to stability clauses—a work that is complicated by the need to coordinate across multiple agencies involved with the NR sector control. Despite dealing with a physical product, high natural resource taxation rates and their business structure may lead to higher-than-average TP risks. In such cases, general TP rules need to be complemented by specific TP rules—and BEPS effective implementation will depend on very precise specification of a complex business at country level. Without specific rules, MNEs may still have ample room to manipulate TP.

Challenge 4: Improving developing countries' ownership and capacity to manage reforms, and sustain an ample dialog with key domestic and international stakeholders.

Different stakeholders will be involved in the implementation of the BEPS package, and tax authorities will need to interact with all of them. Given the heterogeneity of the legal, institutional, and business framework across countries, consultations at the country level will be needed. Building consensus domestically is not an easy task when tax changes are on the table, and this process will demand attention and resources. Some obvious stakeholders that should be included in the BEPS implementation dialog, at the domestic level, are the lawmakers, the judicial system, business associations, and media vehicles. An open dialog with the MNE sector itself will be crucial for successful implementation. The IMF has been encouraging permanent consultations between the tax administrations and the private sector to

[21] In many countries, even the general TP rules are flawed (e.g., many Anglophone developing economies have TP legislation that is still based on the UK's pre-1998 legislation, which is much weaker and not consistent with self-assessment principles).

[22] NR revenues account for over half of government revenues in petroleum-rich countries, but it reached over 80 percent in Angola, the Republic of Congo, Equatorial Guinea, and Nigeria in 2011/2012.

design legal frameworks, to clarify legal and procedural understandings, and to adopt cooperative compliance approaches to manage risks and reduce uncertainty. Concerns of the private sector should be listened to and properly addressed. For example, issues such as data confidentiality related to the preparation and dissemination of the proposed Country-to-Country reports may be a concern where many tax administrations do not have robust IT systems. Discussions about the compliance burden on administrative requirements also need to take place. At the international level, TA providers, donors, and other capacity building partners are also key stakeholders to be involved in the dialog.

However, developing countries struggle to coordinate and manage ample reform implementation on the ground due to lack of capacity and resources. In many circumstances, donor and TA provider coordination is left to the IMF to fill this gap. Coordinating ample dialogs with domestic and international stakeholders on international taxation may also present considerable challenges to developing countries, which need to be in the driving seat of these reforms.

9. CONCLUSION

The BEPS initiative is a unique and welcome opportunity to reform the outdated and flawed international tax framework. The problems of the current system are not new, and have arisen over time, as the technology and business processes have changed, and ill-coordinated tax policies have proliferated. Addressing these weaknesses through a coordinated action was much needed. For a long time, the IMF, the OECD, and other regional and international organizations have said that “global problems require global solutions.”

However, implementing this agenda is not easy and will require additional efforts and resources over the years to come. An inclusive discussion will be needed to address the dissemination of the package to stakeholders that have not been fully engaged in the current discussions and to clarify the package impacts on administrations’ processes and requirements.

This paper identified four key challenges moving ahead: (1) Ensuring that the administration of international tax operations is embedded in a coherent, sound, and wider design of both policy and procedural issues. (2) Implementing the BEPS agenda in a sustainable and sequenced way that is supportive of ongoing foundational tax administration reforms in developing countries. (3) Initiating an inclusive discussion on specific issues and circumstances faced by developing countries in order to facilitate a more effective absorption of the BEPS outputs in low capacity environments. (4) Improving developing countries’ ownership and capacity to manage reforms, and sustain an ample dialog with key domestic and international stakeholders. Underlying these challenges, there is the view that the control of mnes cannot be dissociated from the overall control a tax administration exercises over its universe of taxpayers.

Appendix 1. BEPS Action Plan

The BEPS Action Plan was designed to make progress in 15 areas deemed relevant for improving the international tax framework. A summary of the areas are listed below:

ACTION	DESCRIPTION
Action 1. Address the tax challenges of the digital economy	Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.
Action 2. Neutralise the effects of hybrid mismatch arrangements	Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules); (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention. This work will be co-ordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.
Action 3. Strengthen CFC rules	Develop recommendations regarding the design of controlled foreign company rules. This work will be co-ordinated with other work as necessary.

Action 4. Limit base erosion via interest deductions and other financial payments	Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be co-ordinated with the work on hybrids and CFC rules.
Action 5. Counter harmful tax practices more effectively, taking into account transparency and substance	Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.
Action 6. Prevent treaty abuse	Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be co-ordinated with the work on hybrids.
Action 7. Prevent the artificial avoidance of PE status	Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.
Action 8. Assure that transfer pricing outcomes are in line with value creation- Intangibles	Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.
Action 9. Assure that transfer pricing outcomes are in line with value creation- Risks and capital	Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be co-ordinated with the work on interest expense deductions and other financial payments.

Action 10. Assure that transfer pricing outcomes are in line with value creation- Other high-risk transactions	Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.
Action 11. Establish methodologies to collect and analyse data on BEPS and the actions to address it	Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it. The work will also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g. FDI and balance of payments data) and micro-level data (e.g. from financial statements and tax returns), taking into consideration the need to respect taxpayer confidentiality and the administrative costs for tax administrations and businesses.
Action 12. Require taxpayers to disclose their aggressive tax planning arrangements	Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. The work will use a modular design allowing for maximum consistency but allowing for country specific needs and risks. One focus will be international tax schemes, where the work will explore using a wide definition of "tax benefit" in order to capture such transactions. The work will be co-ordinated with the work on co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international tax schemes between tax administrations.
Action 13. Re-examine transfer pricing documentation	Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE's provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.
Action 14. Make dispute resolution mechanisms more effective	Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.
Action 15. Develop a multilateral instrument	Analyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution.

10. REFERENCES

Arnold, B. and J. Wilson, 2014, "Aggressive International Tax Planning by Multinational Corporations: the Canadian Context and Possible Responses", The School of Public Policy, SPP Research Papers, Volume 7, Issue 29, September 2014.

Bilicka, K. and C. Fuest, 2014, "With Which Countries do Tax Havens Share Information?", International Tax and Public Finance, April 2014, Vol. 21.

Calder, J., 2014, Administering Fiscal Regimes for Extractive Industries: a Handbook, International Monetary Fund, Washington, DC.

Crivelli, E., R. de Mooij, and M. Keen, forthcoming, "Base Erosion, Profit Shifting and Developing Countries"

Dharmapala, D., 2014, "What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature," *Fiscal Studies,* Vol. 35, pp.421–48.

De Mooij, R., 2011, "Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions", IMF Staff Discussion Note, 11/11, May 2011. https://www.imf.org/external/pubs/ft/sdn/2011/sdn1111.pdf

Gravelle, J., 2013, "Tax Havens: International Tax Avoidance and Evasion," CRS Report for Congress, Congressional Research Service, United States.

International Monetary Fund, 2013, "Issues in International Taxation and the Role of the IMF"

International Monetary Fund, 2014, "Spillovers in International Corporate Taxation," Available via the Internet at www.imf.org/external/np/pp/eng/2014/050914.pdf

Keen, M. and R. de Mooij, 2012, "Debt, Taxes, and Banks", IMF Working Paper 12/48.

Lemgruber, A. and S. Shelton, 2014, "Administering Revenues from Natural Resources—A Short Primer", Technical Notes and Manuals, Fiscal Affairs Department, International Monetary Fund.

Lemgruber, A., A. Masters, and D. Cleary, 2015, "Understanding Revenue Administration: An Initial Data Analysis Using the Revenue Administration Fiscal Information Tool", Fiscal Affairs Department, IMF.

McKinsey Global Institute, 2010, Growth and Competitiveness in the United States: The Role of its Multinational Companies, June 2010.

Organization for Economic Co-operation and Development, 2013, *Action Plan on Base Erosion and Profit Shifting* (OECD: Paris).

Organization for Economic Co-operation and Development, 2014, Fragile States 2014: Domestic Revenue Mobilization in Fragile States.

Topic 3.2

WHEN INTERNATIONAL TAX AVOIDANCE BECOMES TAX FRAUD

Guarocuya Felix
Director General of Internal Taxes
(Dominican Republic)

Contents: 1. Overview. 2. International tax planning. 3. Conclusion.

1. OVERVIEW

Each tax system aims to comply in priority with the tax principles established in the Constitution, as well as adapt to the best practices stated by the tax doctrine. The goal of the tax reforms are to fulfill tax, economic and administrative objectives of an ideal tax system. In this context, throughout the years we have worked tirelessly to increase revenues through the implementation of new measures of tax policy and administration.

For this reason, the regulations seek to reduce the legal breaches that are used by taxpayers to reduce their taxation significantly.

However, no country, acting unilaterally, can counter all forms of tax avoidance effectively; therefore multilaterally agreed solutions are the best option.

Taking into account the considerations above and understanding that the main function of the tax administrations is to collect taxes, and at the same time, they have a duty to provide legal certainty to taxpayers. Therefore, it is convenient to analyze the phenomenon of international avoidance when it becomes tax fraud.

In that sense, the objective of this document is to analyse, first, when the international tax planning becomes evasion. Secondly, the history and effects of the phenomenon of international avoidance in the Dominican Republic. To learn the repetitive behaviors in taxpayers to reduce the payment of taxes. Thirdly, what measures are implemented by the tax administration to face this situation, according to international best practices and that could be implemented to continue closing this breach.

2. INTERNATIONAL TAX PLANNING

Over the years, globalization has been the engine of the world economy, the increase and the creation of markets has increased substantially the commercial, financial and service exchange. This situation has favored the emergence of corporations or groups of interrelated companies that operate simultaneously in different parts of the world, which are called Multinational Enterprises (MNEs).

The operations of MNEs are affected by the disparity of tax regimes in countries where they operate. On the one hand, this situation creates double taxation; on the other hand, it is an opportunity for MNEs to reduce their effective tax burden, by using a tax planning which emerges as arbitrage between different tax regimes. However, this planning could create a double no taxation. Therefore, the rise of globalization in economic, financial and commercial processes has deeply affected taxation, both nationally and internationally.

Through an international tax planning, companies or entities may take advantage of the existing differences between countries or territories with greater or lesser fiscal sovereignty[1] to reduce their effective taxation. I.e., that ultimately, this planning responds to an arbitral analysis of differences between the tax laws or tax rates across countries.

It has to be noted that in many cases this analysis responds to conditions of internal tax avoidance. I.e., in the use of legal means, aimed at a reduction of the tax burden, which, necessarily, are outside the scope of criminal legislation, since they are legally irreproachable[2]. In other words, to seek a reduction of the tax burden based on the advantage that provides any regulatory provision, or in absence of a provision[3]. This practice, which is also called *economy option,* allows a tax saving through what the tax laws, expressly or tacitly, make available to the global taxpayers.

International tax avoidance takes place when companies use loopholes or gaps in tax regulations in several countries in order to prevent the taxation or the tax liability in a given tax system less favourable (for taxpayers), producing the taxable consequences in a system more favorable for the taxpayer[4]. However, according to the doctrine, the international *tax avoidance*, to be considered as such, requires two assumptions: first, to deal with two or more tax systems and, secondly, the possibility of choice by the taxpayer between several tax systems, but in an indirect way rather than in a direct way[5].

These behaviors require tax administrations to take adapted measures for minimizing the impact of the ambiguities and legislative loopholes that may occur between the jurisdictions or inside them. Dealing with international avoidance includes anti-avoidance measures against abusive tax planning. This means that the purpose of the

[1] Delgado Pachecho, Abelardo. *Las medidas anti elusión en la fiscalidad internacional.* Nuevas tendencias en economía y fiscalidad internacional, September-October 2005.

[2] Jarach, Dino, *El hecho imponible*. Publishing Abeledo Perrot, Buenos Aires, Argentina, year 1971, p. 119.

[3] Barrera Leticia. *La elusión tributaria y las normas antiabuso*, www.aaef.org.ar

[4] Xavier, Alberto, *Derecho Tributario Internacional*, Livraria Almedina, Coimbra, Portugal.1993

[5] Idem

reduction of the tax burden can go from a simple *economy option to outright evasion or law fraud.*

The possibilities range from the rationalization of tax related activities, using most of the advantages and benefits that give the tax laws (*economy of option*) through the abuse of forms and legal procedures to avoid the occurrence of taxable events (*tax avoidance*). It may end up in open and direct violation of the legal system if the company use fraudulent maneuvers to hide the occurrence of taxable event and renege on the tax liability (*law fraud*)[6].

As a result, anti-avoidance measures constitute legal answers, which aim to prevent the development of avoidance towards the fraud crime, which is obviously illicit[7]. Part of the doctrine considers that the implementation of anti-avoidance measures does not respond to the problem efficiently, since, by generating a complex tax system, it leads to more tax non-compliance[8].

As international tax planning involves several jurisdictions at the same time, measures to control it have been a task of international agencies. Accordingly, measures to combat tax evasion are the result of a policy coordination and agreements between countries, which ensure and provide an effective application of the fiscal, economic and administrative goals of an ideal tax system.

The Global Forum on transparency and exchange of tax information was the first initiative of this kind created as a multilateral framework. It gathers approx.126 countries that have committed to applying an international standard in the field of information for tax purposes. This standard is the automatic exchange of information on request (EOIR), and from 2016, the implementation of the new standard for automatic exchange of information (AEOI) approved by the OECD countries and the G20 will be evaluated.

To this end, the Global Forum has assessed countries through a Peer Review process that is carried out in two phases:

1. Phase I: It examines the legal and regulatory framework for the exchange of information.

2. Phase II: Check the practical implementation of the legal framework.

[6] Cfr. Pires a. Mario. *Evasión, Elusión y Economía de Opción en el Ámbito Tributario*. Coordinator of the CENDECO - UNIMET tax risk assessment program.

[7] Garcia Escobar, Jaime. *La Naturaleza jurídica de la elusión tributaria*. Universidades de las Américas y del Desarrollo, 2004-2005

[8] Ídem

One of the most important actions to reduce international tax avoidance breaches is cooperation, availability, access to relevant tax information exchange between tax administrations. Therefore, each State must be committed to provide the requested information in a timely manner.

In addition, the Organization for the Economic Cooperation and Development (OECD) has developed since 2013 a series of recommendations with the aim of limiting the tax base erosion and transfer of benefits (English acronym BEPS for "Base Erosion and Profit Shifting"). Multinational companies used to take advantage of gaps and divergences between the national tax regulations to transfer artificially profits to places of low or null taxation (double no taxation). Inclusive, they have taken into consideration the limitations of developing countries, since this difference with respect to developed countries leaves open the possibility that multinational companies carry out simpler tax evasion practices, but potentially more aggressive

In essence, all these actions seek to strengthen the legal aspects of taxation in order to eliminate the gaps that allow multinational companies to perform practices of tax planning, as well as to improve the capacity of the tax administration regarding the access and management of information on multinational companies operations.

2.1. Situation in Dominican Republic: Antecedents (1992-2011)

The design of the Dominican tax system is based on the application of multiple tax benefits through the application of special regimes that coexist with the general regime. Tax revenues are based on five groups of taxes that represent more than 85.0% of revenues. These tax figures are the ITBIS (similar to the VAT, value added tax), the income tax, the excise on hydrocarbon, selective taxes on alcoholic beverages and tobacco, and customs duties. In short, the Dominican tax system is described by a high relevance of indirect taxes and narrow tax bases.

According to the OECD report, "*Fiscal Policy for Development in the Dominican Republic"*, the Dominican tax system is characterized by a high fragmentation, hindering its administration and facilitating tax avoidance and evasion[9]. This means that the Dominican tax system has a reduced tax base and a large number of exemptions and tax incentives.

According to these peculiarities, taxpayers plan and carry out their trade relations in order to adjust the fiscal cost through legitimate tax planning. However, there are occasions where these tax programs become abusive or aggressive; when this takes place there is a fraud or a *Law fraud*. Practices of avoidance involve a serious violation to the tax principle of equality, fairness and justice affecting the tax system of the State.

When the simple avoidance becomes fraud, harmful consequences for the development of the country are produced. Among others, we can mention the following:

[9] OECD, *fiscal policy for development in Dominican Republic*. September 2014

- Infringement of the constitutional principles of legality, legal certainty, equity and equality;
- Decrease in tax revenues;
- Distortion of the allocation of resources;
- Damage to commercial competition;

Attending these consequences, anti-avoidance measures were proposed in order to lessen the damage for the State. For these purposes, general regulations were developed. In principle, they consist in granting to the administration the powers to ignore the events or business deeds performed with intention to evade taxes, and apply the legal taxation regime that the scheme is trying to avoid[10].

The law No. 11-92, which establishes the tax code of the Dominican Republic, introduces therefore in its article 2 the principle of substance over form, which is essential to determine the true nature of a taxable event, considering the situations and the real economic relations that are carried out, pursued or determined by the taxpayers.

This principle states that the tax administration is not bound by the legal schemes used by taxpayers, so it is legal to determine the true nature of the activities, ensuring that the real nature of the business is not only for obtaining tax advantages. This provision has been widely used to support challenges under the utilization of legal figures.

In this context, we can mention some of the most frequent avoidance practices used by taxpayers in the Dominican Republic to reduce their taxable income as well as the measures carried out by the tax administration for their control:

a) Deduction of expenses to determine the net income.

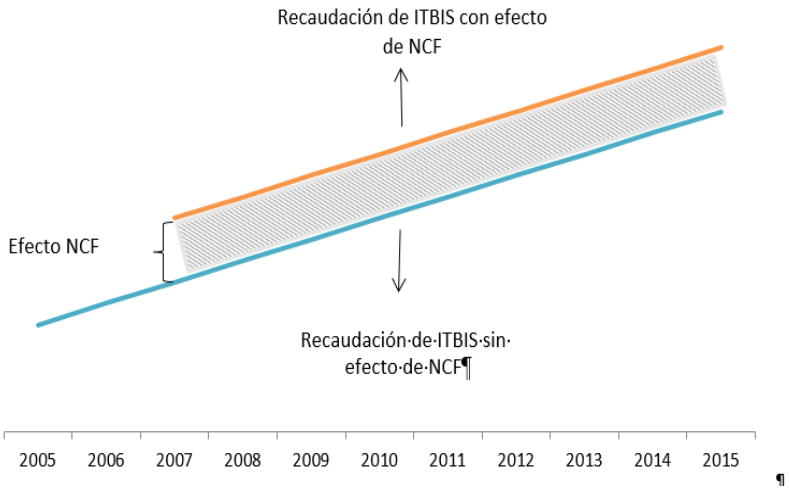
Since the implementation of the tax code, expenses necessary to obtain, maintain and keep the income are admitted as deductibles. Article 287 of the tax code expressly establishes the deductibles expenses.

In 2006, the country issued the Decree No. 254-06 that establishes the rules for the regulation of printing, issuance and delivery of tax vouchers. This decree states the obligation to issue tax vouchers and to keep copies of them for all individuals or legal entities domiciled in the Dominican Republic that carry out operations of transfer of goods, deliveries, or provide services for payment or free.

For purposes of deducting an expense, the transaction must be reported on a legitimate tax voucher. This measure aims at eliminating the deduction of unsubstantiated expenses.

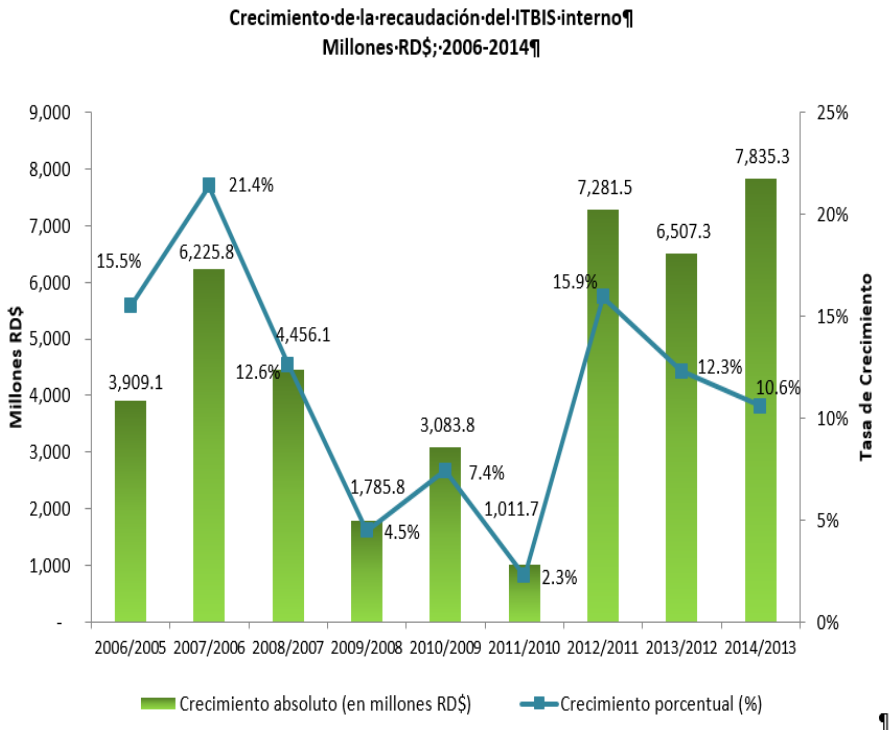
[10] Garcia Escobar, Jaime. *La Naturaleza jurídica de la elusión tributaria*. Universidades de las Américas y del Desarrollo, 2004-2005

Representación·Gráfica·del·Impacto·de·los·NCF¶
sobre·la·Recaudación·de·ITBIS¶
¶



¶

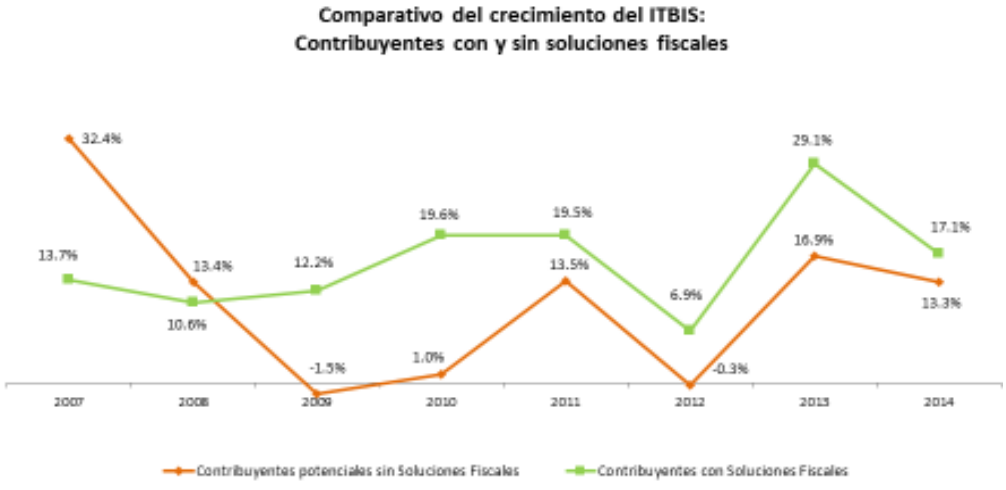
In fact, the tax vouchers have affected positively ITBIS revenues (see chart) and, therefore, the corporate income tax. In this sense, since the year of its implementation in 2008, the collection of these taxes have grown by RD$ 6,934.4 million in respect to 2007 and RD$ 3,314.64 million in respect to the estimated collection.



¶

On the other hand, as a control measure for taxpayers who perform sales and provide services, from 2008 through the regulation N°451 on tax printers (tax solutions), taxpayers have to use electronic devices in their cash registers in order to identify all payments made by credit card or in cash.

This graph shows the effect of the implementation of the tax solutions on the transfer of industrial goods and services tax (ITBIS).



Fuente: Departamento de Estudios Económicos y Tributarios, DGII.

Subsequently, the tax administration issued the General Regulation N° 06-2010 about reliable payments. It establishes that taxpayers who carry out payments exceeding fifty thousand Dominican pesos (RD$ 50,000.0, approximately $1,108.0 at the current exchange rate)[11] in addition to tax vouchers with value of tax credit, should use any of the means set out in the banking and financial intermediation system. The beneficiary should be individualized and, to be admitted as deductible expense or tax credits and other costs with tax effect, the payment should not be in cash.

This measure was a consequence of a tax fraud that was detected because of a company in which intermediaries interfered and used tax vouchers based on fictitious expenses.

b) Implementation of schemes for commercial triangulation through low or zero taxation countries or preferential regimes.

During the 2009 tax period, the tax administration, through the analysis of the operations of import of finished goods and raw materials from a local company with a related company abroad, located in an area considered as a tax haven, detected that a third company located in another country was the one actually carrying and delivering those products. Therefore, the operation through the company located in the tax haven was fictitious, with the sole purpose of reducing the taxation of the group.

However, it is to note that at any time the local company and the one located in the tax haven had the effective ownership of the products. However, the company located in the referred territory was the one selling and invoicing the products for the local company, which then carried out the customs clearance processes and other processes for the receipt of the goods in the host country.

Indeed, the company was using legal schemes like the constitution of companies within the same group and in other jurisdictions, with the aim of increasing production costs without adding any value to the property. The company used in fact these figures to circumvent the substance of the taxable event and the economic reality of the transaction. Since at the time of the audit, the Dominican legislation did not include regulations on transfer pricing, the tax administration challenged the transaction according to the provisions of article 2 of the tax code, which determines that the legal schemes adopted by taxpayers do not bind the tax administration.

In addition, in the tax year 2011, a taxpayer used the business triangulation to carry out tax planning. In particular, a Dominican company manufactured, distributed and exported plastic containers abroad. Through the inspection made to the said taxpayer, it was found that 86% of exports were invoiced to a related company located in a territory, considered by the Dominican Republic as a low taxation jurisdiction or tax haven. The goods were sent directly to independent and related companies located in other

[11] Dollar rate: 45.1

territories, so there was evidence of triangulation, where the legal form adopted was not consistent with the reality of the facts.

In this particular case, the sales price to the related company was in average 8.36% lower than the manufacturing cost, while sales prices to independent had an average profit of 13.87%. It was concluded that the local company assumed losses in sales and let the company abroad benefit from the income when they invoiced the final client.

The tax administration verified and confirmed that indeed it was a triangulation between companies, so it proceeded to deny the validity of the transaction on basis of article 2 of the tax code, about the legal schemes used by taxpayers, which do not bind the tax administration, and article 281 on transfer pricing and valuation of transactions.

c) Erosion of the tax base through transactions between related companies.

The Arm's length principle is registered in the Dominican legislation since the creation of the Dominican tax code in 1992 by the law N° 11-92, article 281. In addition, the regulation N° 139-98 for the implementation of title II of the income tax, in its article 4 defines the criteria to consider that there are economic bonds between companies.

In 2006, guidelines that are more specific on transfer pricing were established, with the Law N°495-06 on tax reform. We can mention that for sectors such as hotel, pharmaceutical, insurance and energy, taxpayers and the tax administration could define Advance Prices Agreements; the treatment applicable to income derived from export and import sectors was also included in this amendment.

Subsequently, as a means to implement the provisions of law No. 495-06, the tax administration issued the Norm 04-2011 on transfer pricing. It includes the main elements of the OECD guidelines: definition of related party and comparable transactions, criteria to take into account for the analysis of comparability, definition of the methods used and their order of priority, operations adjustments and specification of the information obligation.

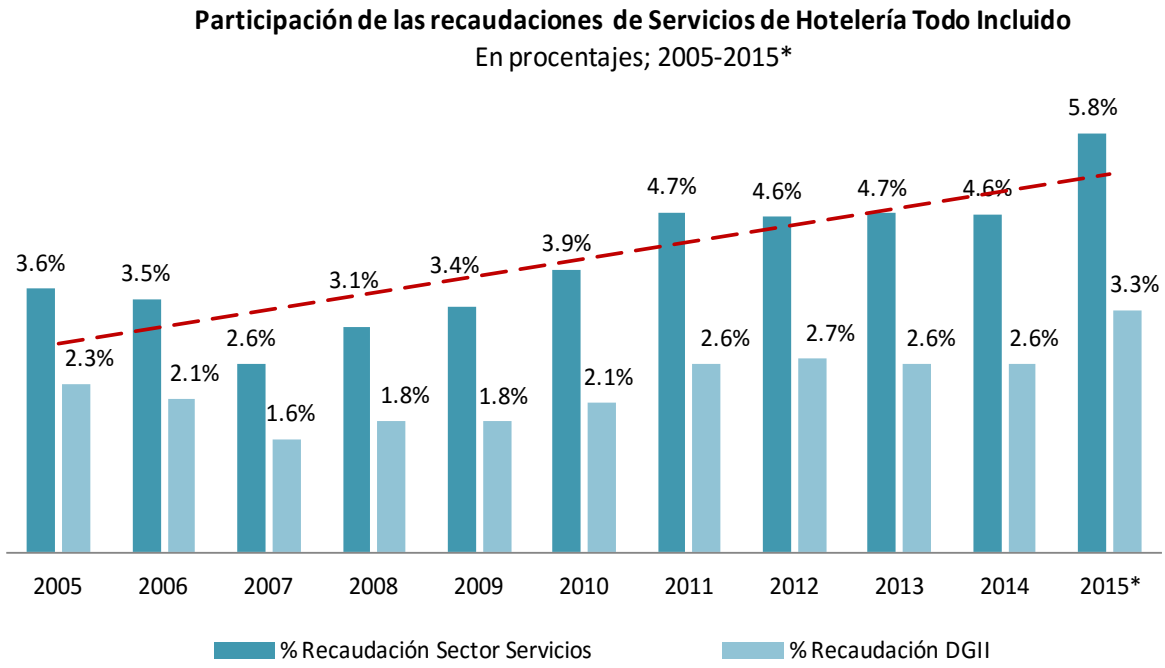
In 2009, the tax administration carried out a control, under the article 281 criteria of the tax code, to a telecommunications company which was carrying out an unsecured financing operation with its related company from abroad and whose payment was carried out in dollars. In principle, it was a profitable operation with a real basis. However, a restructuring of the accounts receivable was made, changing the currency agreed in the loan contract and two months after this change, a currency rate change took place, resulting in a loss of $130.7 million.

In this case, the tax administration proceeded to dismiss the restructuring of loan agreements, leading them to conditions that would have been agreed between independent parties based on transfer pricing regulations. Why would they change the

structure of an operation that is producing effective benefits to a structure loaded with greater risks?

Another important case was, in 2008 and 2009, the examination of the sector of "all inclusive" Hotels. This sector had high connection with companies abroad that facilitated the use of transfer pricing to delocalize the tax base; they used related companies that were marketing of the rooms (Marketers) located in the majority of cases in countries of low or zero taxation; differences in reporting prices per night per guest were dete4cted. The rates were declared for an amount lower than the operating cost and the advertised rates were higher.

For the tax periods from 2007 until 2010, 73 audits were conducted and price adjustments for US $472,055,967.28 million were determined on basis of article 281 of the tax code. The graph here under shows the collection impact on the hotel sector from 2005 to 2015.



From 2010, gross incomes reported by hotels to the DGII increased by 98%

d) **Corporate reorganization:** corporate reorganization is referred to as "*variation of the set of relationships that influence the constitution or operation of the company*"[1]

In this regard, article 93 of Regulation N° 139-98 on implementation of title II of the income tax law. It establishes that "*reorganization is understood* as *all acts which create dissolutions, divestitures or sales, transfers, mergers or takeovers, consolidations and other similar operations, from an entity to another, or with its shareholders. Sometimes it is for the creation of a third entity, or the disappearance of one by absorption, creating another, or between entities that may or may not lose their legal status or their identity as such*.

Article 323 of the tax code provides that the transfer of benefits and tax liabilities must be performed with prior approval of DGII, for purposes of taxation under the principle of fiscal neutrality. On many occasions, the use of this scheme can lead to complex figures that hinder and delay the disclosure of the motive and intention of the business.

In addition, the Decree No. 408-10 on corporate reorganization establishes in its article 9, paragraph I, the approval by the tax administration, in the case of exempted transfers, will be issued taking into consideration the rationale of the reorganization process. It has to be made *for valid economic reasons* o in order to rationalize the activities of the companies involved, without the mere purpose of getting tax breaks.

Therefore, the approval by DGII and the need for an economically valid reason, seeks to close the breach towards tax avoidance. In that sense, it is necessary that the corporate reorganization obey a legitimate business reason justifying it. I.e., what of the Anglo-Saxon jurisprudence called *business purpose test*, i.e., that the planning is acceptable to the extent that has a different commercial or economic purpose than the objective of avoiding a tax.[1].

For this reason, the tax situation of the companies that plan to reorganize must be always assessed and quantified, if any tax prejudice is the product of such reorganization.

Through experience, it could be shown that the majority of taxpayers seek always to perform operations according to an economy of options, i.e., not in violation of the law and always seeking a tax saving. However, it happens that sometimes these fiscal planning involve an abuse of law. When this happen, they switch from a simple economy to a fraud of law.

2.2 Current situation in Dominican Republic (2012-2015)

Law N° 01-12 on the National Development Strategy, in January 2012, establishes in its article 25 as necessary: "to *develop a progressive tax system, giving priority to the direct contribution by expanding the tax base, the rationalization of tax incentives. It must minimize their negative effects on the decisions of economic agents and increase the collection efficiency, under a principle of contribution according to the economic capacity of each taxpayer".*

Based on this legal framework, since the 2012 the tax policy has been based on the increase in the tax base, the collection and the redistributive capacity of taxpayers, as well as reducing the existing complexity and inefficiencies of the tax system. The Dominican State promotes and implements tax policy measures, called anti-avoidance measures, in order to minimize the damage and promote policies that will improve the commerce and the free movement of capital.

In this context, the law N° 253-12 was approved to strengthen the revenue collection capacity of the State for the Fiscal sustainability and sustainable development, with its enforcement regulations No. 50-13 and No. 78-14 on transfer pricing, which introduce anti-avoidance clauses and measures, namely:

a) Precisions on permanent establishment:

Among the changes introduced from this law and its regulations, are the information taken into account around the definition of permanent establishment. Non-resident taxpayers with permanent establishment in Dominican Republic must register with the tax authorities and provide information concerning the persons or entities who are responsible for the, so clearly this measure means to define the authority that pay the taxes for the income generated in the country. Furthermore, these taxpayers are obliged to appoint a resident in the country that represent them in relation to their tax obligations and inform the tax authorities about it.

b) Deduction of interest:

It is one of the most important aspects to develop since tax avoidance through the use of debt among related entities can be performed and with third parties to achieve the excessive deduction of interests or to finance the production of exempted or deferred income and other financial income that are economically equivalent to interest payments. Inclusive, it is one of the BEPS actions to take in consideration and it must limit the erosion of the tax base that has been identified using interest deductions and other financial payments.

With the Act No 253-12, limitations to interest deductions and excessive debt burdens by taxpayers were introduced. Indeed, before such modification interest on debts could be deductible if it was shown that they were necessary to obtain, maintain and preserve the income, and in the case of interest generated by financing obtained abroad, they would only be deductible if the appropriate withholding had been paid.

Currently the first limitation is that interest expense should exist only to obtain, maintain and keep the income. Secondly, the expenditure must be based on a tax voucher number and if it is more than RD$ 50,000.0, (approximately US$ 1,108.0 at the current exchange rate[1]), a non-cash payment method must be used. Thirdly, it is necessary to apply the rules of transfer pricing. Fourthly, the amount of deductible interest will be proportional to the income taxed to the lender, as indicated in articles 306 or 306bis of this code.

The deduction will be limited to the amount arising from applying to the expenditure a ratio between the rate of ten (10%) and the current rate of the income tax for legal entities according to article 297 of the tax code. However, in the event that costs constitute for the lender an income taxed abroad, the deduction will be 100% (one hundred percent) if its final effective rate is equal to or higher than the current rate of the income tax for legal persons according to article 297 of the tax code. If the effective rate is less, the corresponding proportion has to be paid, always within the above-mentioned limit.

Finally, the clause of sub-capitalization applies, which aims to avoid an uneven distribution of benefits within the company group, withdrawing them in the form of interest on the debt and not through the sharing of dividends[1].

In this regard, in accordance with paragraph I of article 287 of the tax code, modified by the law 253-12, it is established that: "*Without prejudice to other rules governing deduction of interest, the deductible amount for this concept may not exceed a specific value. This value result from multiplying the total amount of interest earned in the tax period (I)by three times the relationship between the annual average balance of stockholders (C), and the remaining annual average of all interest-bearing debts (D) of the taxpayer (1 * 3 (C/D).)"* Therefore, the debt ratio is 3 to 1, which means that the company can borrow up to three times their equity.

Sub-capitalization regulations tend to avoid that excessive financial costs transfer the national tax base to another jurisdiction. The applicable regulations is accurate when the transfer occurs between related entities that are subject to the same tax jurisdiction. In other words, the system of transfer prices referred to in article 281 of the tax code of the Dominican Republic is to be applied without prejudice.

Similarly, in 2014, the tax administration issued the General Rule N°. 02-2014 on deduction of interests, which aims to regulate the deduction of interest on debt and costs resulting from their creation, renewal or cancellation. This includes the procedure and the proportion to be applied to the deduction of such interest and over-indebtedness.

The standard has special rules for deduction in the following cases:

1) If loans are subscribed with companies that consolidate their financial statements at their parent company, the taxation rate applied in the State where the lender company headquarters is located will be used to determine the deductible amount.

2) Interest paid on financing that a resident company in the Dominican Republic signed directly with a recognized international body that is not subject to taxation can be fully deductible, with prior approval of the DGII. For these purposes, the loan contract and the documentation that supports the motives for its subscription must be provided.

3) Interest paid for loans or financing underwritten with regulated foreign financial institutions may be deducted in full, provided that:

a. A Dominican society subject to consolidated banking supervision owns more than 90% of the shares of the entity that grants the loan or financing; and
b. The Dominican company that owns the financial institution regulated abroad must perform at least a tax

payment equivalent to the rate of income tax established in article 297 of the tax code applied on 5% of the net income. (After reserves and provisions regulatory, generated by the financial institution overseas during the same fiscal year for which the Dominican institution is presenting its return). This payment must be made more no later than the deadline for the income tax return established in the tax code.

When the statement and payment of income tax on remittances received by financial gain of the regulated financial institution located abroad, in accordance with article 269 of the tax code, does not reach the 5% established in paragraph b) designated above, the owner may complete the difference, through a payment on account.

The payment established in the previous paragraph will be used as a credit at the time of the return and payment of income tax for the profits transferred to the Dominican Republic by the regulated entity, from abroad, in accordance with article 269 of the tax code.

When, for reasons of foreign regulations, it becomes impossible for the Dominican society to carry out the payments established in the literal B and paragraph I of the aforementioned article, may request the DGII for a partial or total dispense of the payment. This request must be made by written communication, with relevant evidence demonstrating the said impossibility. The DGII will evaluate submissions and request all the information in order to verify the allegations. The DGII will issue a resolution about its decision on the case.

c) Transfer pricing:

By the law No. 253-12, the article 281 of the tax code is amended in order to give status of law to Rule N°. 04-11 on transfer pricing and improve some aspects on the issue, highlighting: points of anchor: related resident party (due to special regimes), related non-resident party and operations, preferential tax regimes, costs sharing agreements, rules to determine comparable and individual Advance Pricing Agreements.

Subsequently, the Regulation No.78-14 on transfer pricing was published, including regulations governing corporate cost-sharing agreements, in order to have them sent to the tax administration prior to the execution of expenditure and to be approved by the tax administration in case of corporate expenses distribution with residents in preferential tax regimes. Similarly, costs sharing agreements were regulated, which should clearly define the activities to be performed, the risks involved, the reported assets, costs and expenses, among others.

Transfer pricing is determined taking into account the factors of comparability that have been established by the OECD, as well as the application of the assessment method for the determination.

One of the main provisions included in the modification of article 281 with the law 253-12, is that taxpayers, either individually or by sector can ask the tax administration, an agreement in the field of transfer pricing. This agreement set the values of commercial and financial operations carried out by other related parties, prior to their execution and for a specific period. Such a request must be accompanied by a proposal that should describe the comparability factors considered relevant according to the characteristics of the operation, selection of the most appropriate method, among others.

d) Abuse of conventions:

It is associated with behaviors that take advantage of the provisions arising from an agreement to avoid double taxation, in order to relieve or eliminate the tax burden through the creation of circumstances that come into collision with the spirit and the objectives pursued by the States when they sign a specific convention.

One of the figures most commonly used in relation to the conventions is the *"treaty shopping"*, which is no more than the phenomenon whereby an individual seeks to utilize the benefits of a convention to which it would not have right. It is abusive, as exploiting structures that do not possess a substance according to the type of business, or infringes the object and the purposes of the Convention. Since the abuse of the conventions is an imminent reality, is clauses anti-abuse are usually included, as a response to deal fairly with the abusive tax planning.

In that sense, our country has to date, signed two conventions to avoid double taxation: one with Canada, signed in 1976 and the other with Spain, signed in 2011. In these agreements, provisions are set to prevent abuse of the benefits of the conventions, so include the following clauses:

Clauses	Agreement between Canada and the Dominican Republic to avoid double taxation and prevent tax evasion	Agreement between the Dominican Republic and the Kingdom of Spain to avoid double taxation and prevent tax evasion
Residence	See Article 4	See Article 4
Beneficial owner	Articles describing the treatment of dividends, interest and royalties.	Articles describing the interests, dividends, royalties and other income
Real estate companies	Article 13.	Article 14.

Including these effects, this agreement between the Dominican Republic and the Kingdom of Spain to avoid double taxation and prevent tax evasion, indicates in its Protocol, a limitation to these benefits. It indicates that it will not be interpreted to prevent a Contracting State from applying the provisions of its domestic legislation relating to the prevention of tax evasion and avoidance.

A mutual agreement procedure, which is part of the BEPS project, is provided for resolving differences on the concept of residence for the purposes of the conventions. So far, the Dominican Republic has had no experience in this regard.

These provisions avoids triangulation operations and interposition of intermediaries to benefit from the agreements.

In fact, the Dominican Republic has made efforts to adjust its tax system to international standards. It has been determined that international taxation policy should be an essential part of the new taxation through the Fiscal Pact to be signed in the medium term. In that sense, it would contain aspects such as:

1. Inclusion of a general anti-abuse close (GAAR).

2. Establish the negotiation strategy for Tax Agreements.

3. Adapt the legislation for the automatic exchange of information.

4. Adapt the tax code in accordance to international standards of information management and confidentiality.

3. CONCLUSION

The regulations implemented against tax avoidance constitute legal measures that aim to prevent the development of tax fraud. However, they generate a complex tax system, away from the principle of simplicity that should prevail in modern tax regimes.

In addition, the Dominican Republic is in the process of implementing new anti-avoidance measures. The Ministry of finance in conjunction with the Ministry of Foreign Affairs has started the process of assessing applications of Conventions to Avoid Double Taxation and Tax Information Exchange Agreements.

In addition, in November 2013 the Dominican Republic has joined as member the Global Forum on transparency and exchange of tax information, and initiated the peer review in June 2015 with phase I, and phase II in December 2015. For purposes of this membership, through the implementation of a strategy of negotiation, it was agreed to negotiate and sign, first, the Tax Information Exchange Agreements as part of the requirements of the Forum. However, the negotiation of Agreements to Avoid Double Taxation will take place from the entry in force of the Fiscal Pact contained in law No. 1-12 of National Development Strategy.

For these purposes, an adaptation and update both models of Convention has been performed. The Exchange of Information Agreement Model of the Dominican Republic includes new standards for the automatic exchange of information, on request as well

as spontaneous. The Dominican Republic has also requested to join the Multilateral Convention on Administrative Assistance in order to exchange information automatically. In terms of the Model Convention to Avoid Double Taxation, the BEPS Action Plan has been taken into account. In that sense, the model of Convention to Avoid Double Taxation includes:

a. The use of the expression "*abusive arrangements*" for the purposes of avoiding residents of a third State to obtain the benefits of the Convention.

b. Provisions to prevent that hybrid instruments (including the individual companies) and companies with dual residence benefit from improperly using conventions.

c. Specifications in relation to the consideration of a permanent establishment. It is understood as a fixed place of business that a company use or keep if that same company or an associated company carries out commercial and business activities in the same place or in another place of the same Contracting State. It applies when none of the places constitutes a permanent establishment but the combination of the activities carried out are not exclusively of a preparatory or auxiliary character.

d. Provisions regarding action 6 BEPS, to prevent avoidance when it comes to the participation of individuals other than entities shares and avoid is to modify the percentage of real estate at the date of the disposal (incorporating other assets, not real estate assets). The requirement is extended to any day in the previous year.

e. Regulations on the effectiveness of the friendly procedure, since although it is not established that an arbitration provision must be incorporated compulsorily, it is convenient to have one for cases in which administrations have failed to reach an agreement.

Following these amendments to the convention models, the country also has as an initiative, for the purposes of minimizing gaps of avoidance, to join the Multilateral Group of the OECD, which will negotiate and work on the changes to bilateral tax treaties.

Apart from the modifications to the Convention models and the inclusion of the OECD Multilateral Group, the Dominican tax administration is in the process of improving the taxpayers' information records. To this effect, the institution has signed agreements with other State institutions for maintaining and establishing a broad framework of collaboration and exchange of information addressing different areas that possibly could affect taxpayers and the fulfillment of their obligations. All levels of Government will act together in compliance with anti-avoidance public policies.

In conclusion, the main challenges of the country to international taxation are the adaptation of the tax legislation, the monetary law and adoption of short-term measures to respond to international commitments, such as the FATCA of the United States and the Global Forum on transparency, among others. We are also aware of the measures to be taken to assume the BEPS initiative. To these ends, the country understands that previous commitments involve the adaptation of a number of laws to ensure transparency and entail a change in the operational culture of the public and private institutions of the Dominican Republic. This will lead to an automatic protocol for the exchange of tax information with the international community in the fight against tax avoidance and tax fraud.

Topic 3.3

TAX CONTROL OF CROSS-BORDER OPERATIONS AND TRANSACTIONS

Tracing trails: Implications of Tax Information Exchange programs for Customs Administrations[1]

Chang-Ryung HAN, Rachel McGauran
World Customs Organization

Contents: Abstract.1. Introduction. 2. Tax information exchange. 3. Implications for customs administrations. 4. Conclusion. References

ABSTRACT

As cross-border tax evasion and avoidance have been deemed a global scourge since the global financial crisis of 2007-2008, the G20 has supported multilateral automatic tax information exchange as a global measure against it. The Organization for Economic Cooperation and Development (OECD) has, since the late 1980s, promoted tax information exchange between tax authorities in order to help its member states identify residents' incomes and assets contained in tax havens. The global customs community could benefit from a similar type of endeavor as cross-border trade on which customs administrations impose levies is as susceptible to tax evasion as other cross-border economic activities. Additionally, revenue generated by customs administrations accounts for a considerable share of government tax revenue. The World Customs Organization (WCO) has developed a variety of instruments and tools facilitating the exchange of customs information for its Members. Customs administrations hoping to benefit from the exchange of customs information can focus on identifying trails that trade transactions leave not only in export countries and other competing import countries but also the trade payment process.

[1] This paper is an updated version of: Chang-Ryung Han & Rachel McGauran 2014, 'Tracing trails: implications of tax information exchange programs for customs administrations', World Customs Journal, vol. 8, no. 2, pp. 3-13 (www.worldcustomsjournal.org) and has the permission of the publishers of the original paper, the International Network of Customs Universities (INCU) and of the authors to be included in the Conference Proceedings. This article should not be reported as representing the views of the WCO. The views expressed in this article are those of the authors and do not necessarily represent those of the WCO or WCO policy.

1. INTRODUCTION

Discussions on fiscal transparency and the exchange of tax information were top of the agenda for G8 Leaders who met in Loche Erne, Northern Ireland in June 2013. During the G20 summit that ensued in St. Petersburg, the global leaders agreed to adopt multilateral automatic tax information exchange as a new global norm to tackle cross-border tax evasion and avoidance. In fact, efforts to control cross-border tax evasion and avoidance which exploits tax havens began as early as the 1960s[2]. However, the global leaders' renewed concern can be attributed to the global financial crisis of 2007-2008 and subsequent global tax scandals involving tax havens (Scott 2012; Tobin & Walsh 2013). Irrespective of whether tax havens can be held to account for the global financial crisis[3], global leaders, prioritizing the restoration of strong and sustainable growth in the world economy, have emphasized the importance of fighting cross-border tax evasion and avoidance not only for prevention of tax revenue loss involving tax havens but also fair taxation (Cameron 2013; Nicodeme 2009).

The ultimate goal of tax information exchange is to locate and levy taxes on hidden tax base due to bank secrecy laws and national jurisdictions. The OECD has, since the late 1980s, promoted tax information exchange between tax authorities in order to help its member states identify residents' incomes and assets contained in tax havens. However, the OECD's tax information exchange initiative does not include information concerning customs duties. Furthermore, the G20's renewed focus on cross-border tax evasion and avoidance does not take into account the global customs community's concerns and activities, in spite of the fact that cross-border trade on which customs administrations impose levies is as susceptible to tax evasion as other cross-border economic activities. Additionally, revenue accrued by customs administrations account for a considerable share (in some cases up to 30%) of government tax revenue (WCO 2015).

Fulfilling one of their primary roles, levying taxes on cross-border trade and chasing illicit trade transactions, customs administrations have come to realize that information exchange not only with foreign customs administrations but also with other domestic relevant authorities is necessary. Although the global customs community has explored ways to exchange trade data for over a decade, it has not achieved a fruitful outcome yet. In this respect, the OECD's tax information exchange initiative with support from the G20 must be a renewed impetus amongst the global customs community.

[2] The U.S. tried to hold a tight rein on tax havens in the 1960s (The Economist 2013). The OECD in 1998 introduced the Harmful Tax Practices initiative in order to discourage the use of preferential tax regimes and to encourage effective information exchange among tax authorities. As part of the initiative, the OECD produced a list of tax havens in 2000 (Dharmapala 2008).

[3] It is true that many special purpose entities/vehicles were located in tax havens/offshore financial centers. However, according to many scholars and professionals, tax havens are not necessarily a cause of the global financial crisis of 2007-2008 (Palan 2010).

Analysis of the progress of tax information exchange and implications of such an exchange of information would be useful for customs administrations and could re-invigorate momentum for inter-connectivity of customs administrations.

2. TAX INFORMATION EXCHANGE

Background

Cross-border tax evasion and avoidance; issues which G20 Leaders have agreed to tackle, stem from an increased tax base mobility and the resultant tax competition (Avi-Yonah 2000; Genschel & Schwarz 2011). Since the 1950s, as the world has become increasingly globalized, cross-border mobility of taxable assets and activities, such as capital, labor, corporations, goods and services, has greatly increased (Nicodeme 2009). As the tax burden for tax payers is greatly influenced by the withholding taxes of source countries, that is those countries where taxpayers work and invest, some taxpayers have moved workplace, assets, and businesses to low-tax jurisdictions in order to dodge a higher rate of taxation. Some small countries[4] have lowered their tax rates and enhanced bank secrecy laws in order to attract new tax bases and afford protection to those who would otherwise face prosecution in their countries of residence (Genschel & Schwarz 2011; Keen & Ligthart 2006). For instance, wealthy individuals open (anonymous) bank accounts in low-tax countries, such as tax havens, and transmit their incomes and assets in order to avoid their residence countries' high taxation (Hines 2010; Zucman 2014). Multinational corporations (MNCs) establish subsidiaries in low-tax countries and undertake intra-firm trade[5] and intra-firm finance[6] with their subsidiaries, thereby shifting and leaving their profits in low-tax countries in order to avoid a high taxation from host countries in which parent companies operate. However, unlike tax payers operating cross-border, tax authorities remain confined to their national borders (OECD 2012). It has therefore become increasingly difficult for tax authorities to identify undeclared tax bases[7], unless tax payers declare their incomes and assets overseas honestly (Thuronyi 2001), and to impose taxes on elusive transactions involved overseas, unless foreign jurisdictions cooperate in tax administration (Zucman 2014).

[4] For small countries, a cut of tax rates is likely to bring in more revenue gain by an increase in inbound flow of tax base than revenue loss by it (Genschel & Schwarz 2011; Keen & Ligthart 2006). However, contradictory evidence is also provided that tax havens may not intensify tax competition to the extent that might be anticipated (Tobin & Walsh 2013).

[5] Parent companies of MNCs tend to export goods or services at lower prices to subsidiaries in low-tax countries and import them at higher prices from subsidiaries in order to maximize their profits by exploiting different tax rates and leave the profits in low-tax countries (Clausing 2006).

[6] MNCs have subsidiaries in low-tax countries provide subsidiaries in high-tax countries with investment in the form of internal loan (debt), not equity, in order to reduce their taxable income by deducting interest payments (Buettner & Wamser 2013).

[7] Many countries tax their residents' overseas income and assets in accordance with the residence principle (Genschel & Schwarz 2011).

The OECD launched an initiative in the late 1990s aimed at encouraging its members to harmonize their tax rates in order to reduce tax differentials whilst simultaneously persuading low-tax jurisdictions to raise their tax rates. However, this initiative triggered much discussion about possible infringements on national tax sovereignty. Since then, the OECD has adopted a two-pronged approach to deal with unfair tax base eroding. In order to levy taxes on wealthy residents' incomes and assets concealed in offshore financial centers, the OECD has reoriented its focus on the exchange of information on a tax base whereby countries do not need to give up any of their national tax sovereignty in taxing their own residents and can help others to exercise their sovereignty in taxing their citizens (Keen & Ligthart 2006; Nicodeme 2009). In order to tackle MNCs' profit shifting activities, the OECD has focused on closing loopholes incurred from different corporate income tax rules and harmonization of international tax regime (Brauner 2014). Due to different natures of the two cross-border capital flows[8], the OECD's exchange of information initiative is concentrated on discovering residents' incomes and assets concealed in tax havens more than tackling MNCs' profit shifting, although exchange of information also can be useful in addressing MNCs' profit shifting (Tanzi & Zee 2010). In fact, since the end of 1980s the OECD has endeavored to encourage exchanges of tax information between tax havens and other countries for over a decade[9]. After the global financial crisis of 2007-2008 and the resultant focus on fiscal transparency, the G20 committed to the establishment of a new global standard for automatic exchange of tax information.

Types of information exchange and legal frameworks

There are three main types of tax information sharing: on request, automatic, and spontaneous. Information exchange on request involves transmitting tax information in response to a specific request from the residence country. An automatic exchange of information enables tax authorities of the source country to pass all tax-relevant information, periodically, to the residence country with whom they have agreed to exchange information. In the latter concept, spontaneous information exchange, the authorities of one country, on their own initiative, send information which may be acquired in the course of an audit to the tax authorities of another country, believing that it would be of interest to them (Keen & Ligthart 2006).

The most common form of information exchange is known as information exchange on request.

[8] The composition of the cross-border capital flows has increasingly been shifted from foreign direct investment (FDI) towards portfolio investment (PI) since the mid-1970s. As FDI is more sensitive to non-tax factors, such as political stability and supplies of labor and natural resources, than PI, FDI is less prone to tax arbitrage than PI. It is easier to identify providers and recipients of FDI (Tanzi & Zee 2010).

[9] Until the global financial crisis, most tax havens did not comply with the OECD's exchange of tax information and declined treaties for information exchange. In April 2009, under the auspice of the G20 Leaders, the OECD specified that each tax haven should conclude at least 12 information exchange treaties and listed 42 non-compliant tax havens (Johannesen & Zucman 2014).

However, since information exchange on request is premised on requests for information on specific tax payers, the tax authorities have difficulties in making use of this type of information exchange without a grounded suspicion of an instance of tax evasion or avoidance (Johannesen & Zucman 2014). In addition, information sharing with another country is not necessarily in a country's best interests (Keen & Ligthart 2006; OECD 2012) and information is not transmitted as efficiently or as promptly as those countries that require the information would expect. Thus, the EU and the US have opted to support automatic exchange of tax information.

Table 1
Types of information exchange and their legal frameworks

	Bilateral approach	Multilateral approach
Exchange on request	• Double taxation treaties • Tax Information Exchange Agreements	• EU Mutual Assistance Recovery Directive • OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters
Automatic exchange	• Double taxation treaties (e.g., FATCA of the US) • OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters	• EU Savings Tax Directive • EU Administrative Cooperation Directive

Source: the authors

Irrespective of the different types of information exchange, tax information exchange is always predicated on a legal foundation (Keen & Ligthart, 2006). There are a number of legal instruments in place to support tax information exchange. These instruments are categorized into three forms: double taxation treaties, multilateral conventions, and other bilateral agreements outside tax treaties. Most tax information is exchanged through double taxation treaties, which are concluded to avoid double taxation[10] and to prevent cross-border tax evasion (i.e., double non-taxation) (Thuronyi 2001). Many countries have also entered into bilateral agreements solely concerned with information sharing[11]. These agreements are sometimes intended to strengthen information sharing provisions in existing applicable double taxation treaties (Keen & Ligthart 2006).

[10] Most countries assert a right to tax both residents on their world-wide income from domestic and foreign sources under the residence principle and domestic income earned by domestic or foreign owners under the source principle (Genschel & Schwarz, 2011).

[11] Many double taxation treaties are concluded on the basis of the OECD Model Tax Convention on Income and on Capital (Owens & Bennett 2008) and the OECD Model Agreement on Exchange of Information on Tax Matters became the basis for Tax Information Exchange Agreements (TIEAs) (Nicodeme 2009).

The bilateral approach, however, entails not only considerable costs with regards to the negotiation and amendments of agreements (Thuronyi 2001) but also engenders difficulties associated with the third-country problem: non-cooperating third countries benefit more from information exchange cooperation than cooperating countries due to an increase in the inbound flow of tax base evading tax in the so-called 'cooperative countries' (Genschel & Schawz 2011; Johannesen & Zucman 2014).

In response to these problems, a number of multilateral agreements on information exchange have been concluded. The major multilateral instruments are the EU Mutual Assistance Recovery Directive, the EU Savings Tax Directive, and the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters. The EU Mutual Assistance Recovery Directive[12] provides for the exchange of information on request on direct taxes and certain indirect taxes (value-added tax and excises) among authorities of the EU (Keen & Ligthart 2006). The EU Savings Tax Directive provides for automatic information exchange (as distinct from a simple request mechanism) on interest accrued from savings (OECD 2013b). The EU Administrative Cooperation Directive expands the scope of automatic information exchange to encompass income from employment, director's fees, life insurance products, pensions, and immovable property (EC 2013).

Table 2
Automatic tax information exchange systems

	The revised EU Savings Tax Directive	The EU Administrative Cooperation Directive	The Foreign Accounts Tax Compliance Act of the US
Subject of information exchange	Savings income, Investment funds, pensions and innovative financial instruments, and payments made through trusts and foundations	Income from employment, director's fees, life insurance products, pensions, and immovable property	Foreign accounts of the U.S. taxpayers
Contracting parties	27 EU member states	27 EU member states	73 jurisdictions as of September 2015
Effective date	March 2014	January 2015	March 2010

Source: the authors

[12] This Directive was originally introduced in 1976 in the name of the EC Mutual Assistance Directive and was adopted in 2010 after consolidation following a number of revisions (O'Shea 2010).

The OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters[13] contains a provision for the automatic exchange of information on a broad array of taxes covering direct taxes and virtually every form of indirect taxes (excluding customs duties) levied at both national and local level (Genschel & Schwarz 2011). However, the Convention's automatic exchange framework is not a typical multilateral agreement. The information exchanges are based on a unique set of integrated bilateral treaties; they require a separate agreement between the competent authorities of the parties, which can be entered into by two or more parties thus allowing for a single agreement with several parties (with actual automatic exchanges taking place on a bilateral basis) (Keen & Ligthart 2006; OECD 2013b). The Convention was amended in response to a demand from the G20 in 2009 to align it to the international standard on exchanges of information and to open it to all countries, in particular to ensure that developing countries could benefit from the new, more transparent, environment. As of September 2015, the number of signatories to the Convention is 87[14] (OECD 2013a). While the OECD[15] has conducted peer-review evaluations to assess whether agreements for exchange of information are properly transposed in contracting parties' national legislations, several studies have attempted at measuring the effectiveness of the OECD's initiative. They have demonstrated that bilateral agreements for exchange of information have resulted in relocation of deposits between tax havens rather than repatriation of funds from tax havens and supported the OECD's multilateral approach to cross-border tax evasion and avoidance with automatic exchange of information (Johannesen & Zucman 2014).

3. IMPLICATIONS FOR CUSTOMS ADMINISTRATIONS

Even if goods cross borders, customs administrations do not engage in cross-border taxation as customs administrations only impose customs duties and other taxes on goods in accordance with the destination principle. Nevertheless, the OECD's tax information exchange initiative has several implications for customs administrations. In fact, customs administrations are deemed with a longer history of information exchange than any other authorities. That is because, as customs administrations not only deal with a variety of risks but also their jurisdictions are usually confined around borders, exchange of information with competent authorities and foreign customs administrations is a required element for proper customs functioning. In particular, information exchange with relevant authorities enables customs administrations to trace trails that traders leave behind and to identify elusive tax bases.

[13] In addition to automatic information exchange, the Convention features tax examination abroad and simultaneous tax examinations and international assistance in the collection of tax debts (Keen & Ligthart 2006).

[14] The number of contracting parties of the Convention was only 9 by 2003 and increased to 17 by 2009. Since 2010, 61 countries have signed in the Convention.

[15] In 2000, the OECD established its affiliate called the Global Forum on Transparency and Exchange of Information for Tax Purposes that deals with the business of promoting and facilitating exchange of information beyond the OECD members.

However, exchange of information with the global customs community has barely been addressed at multilateral level in a systematic manner. The OECD's exchange of information initiative is anticipated to galvanize the momentum for customs administrations' exchange of information.

Information exchange between customs administrations

Goods upon which customs administrations levy taxes leave trails in both import and export countries. Customs administrations of such import countries could leverage data contained in export declarations sourced from export countries when auditing import declarations in order to verify their accuracy by comparing import data and the corresponding export data. This is a basic need and mechanism for customs administrations' exchange of information (Nitsch 2012). In response to the need for trade information exchange between customs administrations, the global customs community has developed various mechanisms for exchanging information between customs administrations. These mechanisms are suitable for both enforcement and trade facilitation purposes, and include the exchange of best practices, intelligence, and individual trade transactions.

The WCO has provided instruments and frameworks to support information exchange between customs administrations. The WCO Council adopted the International Convention on Mutual Administrative Assistance for the Prevention, Investigation and Repression of Customs Offences (known as the Nairobi Convention) in 1977 to enable multilateral mutual assistance including the exchange of enforcement intelligence and assistance during investigations. In 2003, the WCO developed the International Convention on Mutual Administrative Assistance in Customs Matters (known as the Johannesburg Convention); this Convention has not entered into force. The WCO revised a Model Bilateral Agreement on Mutual Administrative Assistance in Customs Matters for a more enhanced mutual assistance process in 2004. Based on the WCO Model Bilateral, many customs administrations have concluded mutual administrative assistance agreements including MOUs and have exchanged enforcement information and intelligence spontaneously or on request. In addition, the WCO has developed the Globally Networked Customs framework to standardize and facilitate the exchange of commercial and enforcement information. Recently, several customs administrations have succeeded in exchanging not only static information, such as information on authorized economic operators, but also recurring commercial data, such as export and transit data. The WCO is undertaking standardization of the information exchange cases in the form of modules called utility blocks to ensure that the information contained therein is share with other customs administrations. In order to accelerate the exchange of enforcement information, the WCO operates the Customs Enforcement Network (CEN) platform, which encompasses databases and communication tools. The WCO encourages the exchange of information regarding smuggling of illegal drugs, tobacco, counterfeits goods, and endangered flora and fauna via the CEN database and coordinates enforcement operations and projects via CENcomm.

The global customs community has a distinct advantage over tax authorities in the realm of information exchange. Trade data exchange is less complex than tax information exchange. Unlike tax information which tax authorities source from financial institutions to share with foreign tax authorities, records of trade transactions already exist within customs administrations. In addition, customs administrations do not face the 'third-country problem' when exchanging trade data. In other words, the trade tax base (i.e., trade transactions) is not as mobile as other tax bases (e.g., capital) in terms of taxation; the mobility of trade transactions is determined by importers; trade taxes are imposed in the destination country, and high trade tax rates and trade data exchange do not have a direct influence on importers when deciding which goods to import. In spite of the favorable environment which is alleged to exist for customs information exchange, the WCO has faced significant hurdles in its efforts to facilitate information exchange. Most customs administrations have barely conducted bilateral exchange of information with foreign customs administrations in a systematic manner as tax authorities have recently rolled out automatic exchange of information. Some customs administrations do not think an OECD-style exchange of information is necessary for them because they have, if sporadically, exchanged information only with their reliable counterpart customs administrations; they believe that exchange of information between customs administrations is an informal business on the basis of mutual trust and human network.

Some customs administrations hesitate to engage in exchange of information with foreign customs administrations, even if they actually want to do so. There are at least two reasons identified. First, customs administrations of import countries do not possess a right to claim information on export goods from exporters or from customs administrations of export countries, whereas tax authorities of residence countries have justification to request their counterparts of source countries information on their residents' incomes and assets stayed in source countries because they have a right to impose taxes on the incomes and assets of their residents living in source countries. Second, they are reluctant to exchange information with foreign customs administrations because their national legislation restricts disclosure of trade transactions data, especially values of goods, to a third party including foreign customs administrations. The national legislation is a ramification of the WTO Customs Valuation Agreement Article 10 stipulating that all information is provided to customs administrations for the purposes of customs valuation shall be treated as strictly confidential and shall not be disclosed. The relationship between exchange of information and Article 10 of the WTO Customs Valuation Agreement was discussed at the WTO and the WCO in 2003, while the Doha Round negotiations among the WTO members were made (Goorman & De Wulf 2005). The two organizations conceded that exchange of information between customs administrations for the purposes of the fight against customs fraud does not contravene the confidentiality clause (WCO 2003). More than ten years later, in line with the approach to exchange of information between customs administrations, the WTO inserted in its Trade Facilitation Agreement (TFA) a clause (Article 12: Customs Cooperation) to facilitate exchange of information between customs administrations. However, the exchange of information stipulated at the WTO's FTA is confined to exchange of information on request.

Despite under the unfavorable circumstances, before the WTO's TFA was concluded, several countries experimented bilateral exchange of trade transactions data in a systematic way. The trade transparency unit (TTU) of the United States Immigration Customs Enforcement (US ICE) and similar organizations of Argentina, Brazil, Colombia, Paraguay, Mexico and Panama shared the whole import and export declarations data with each other and compared import (export) declarations from the United States with corresponding export (import) declarations of the other participating countries in order to identify any anomalies in trade transactions (Zdanowicz 2009). In particular, Operation Deluge, a collaboration between US ICE and Brazilian authorities conducted in 2006, focused on the analysis of trade transactions data and resulted in the detection of the evasion of Brazilian customs duties and taxes amounting to more than 200 million USD. The reason that this somewhat radical type of exchange of information could come into play may be that participating countries had in common a heightened concern about illegality in cross-border trade and a belief that sharing of customs declarations (i.e., establishing a common database) between participating countries could prevent an imbalance in exchange of information between customs administrations.

However, the methodology, comparing import declarations and corresponding export declarations, cannot achieve its goal to detect anomalies in cross-border trade transactions when import declarations and corresponding declarations are coordinated in advance by importers and exporters that are in special relationships. In particular, goods which have a global reach and benefit from global consummation may require a different approach. MNCs trade globally-sold goods intra firm and are less likely to leave a visible trail of discrepancies between export and import declarations. However, they could leave differing trails in different import countries. Customs administrations could identify price differentials among the same goods, which can lead to the detection of under(over) valuation, by comparing import declarations of different countries. In practice, several customs administrations unofficially managed to exchange information on the prices of goods that were exported by MNCs. There is little evidence as to how much information was exchanged and how such exchanged information was used to detect under(over) valuation of MNCs; nonetheless, an analysis of the prices of identical goods traded amongst MNCs could potentially help to tackle the issue of transfer pricing. The establishment of an intra firm trade database, and the sharing of information concerning the price of goods traded intra firm between customs administrations could prove to be an effective remedy to the issue of transfer pricing amongst MNCs.

Information exchange with tax authorities

According to a conventional notion, customs administrations and tax authorities differ in tax collection, even if both of them are revenue collection authorities, because whereas tax authorities levy taxes on incomes, assets, services, and goods "periodically", customs administrations collect taxes on goods "at the stage of clearance" of goods at borders.

They have developed tax examination and collection methods somehow separately, even if in some countries tax authorities and customs administrations work together under the same roof in the form of autonomous revenue authorities[16] (Crandall 2010). However, while the proportion of trade taxes in the governments' coffers has decreased (Keen & Simore 2004), more and more customs administrations have adopted post-clearance audits as a main tax examination method in order to provide traders with speedier clearance environment. As a result, customs administrations have opportunities to periodically re-assess their decisions on tax imposition at the stage of clearance. Customs administrations also have a temporal space to attempt at and make use of exchange of information.

Importers leave trails not only during the customs clearance process but also whilst filing tax returns and processing trade payments. Customs administrations can uncover hidden tax base and help tax authorities improve their enforcement performance by comparing customs' trade data and relevant data from tax authorities. The type and extent of exchange of information between customs administrations and tax authorities is greatly influenced by the relationship between customs administrations and tax authorities. For instance, autonomous revenue authorities where customs administrations and tax authorities work together under the same roof are likely to exchange information between the two organizations more actively than two independent authorities. Of course, in some revenue authorities, customs administrations and tax authorities have little chemical interaction between the both parties, such as exchange of information and joint audits.

As far as information exchange between customs administrations and tax authorities is concerned, customs administrations are not as dependent on information from tax authorities regarding traders' incomes and assets in their daily activities as is imagined. Nonetheless, information regarding imports and exports from tax authorities could prove beneficial; the information pertains to purchases and sales of traders from the perspective of the tax authorities. In other words, traders' imports (exports) of goods from (to) other countries are seen as purchases (sales) of goods from the perspective of tax authorities. Since all imports are supposed to be reported as purchases (i.e., cost) to tax authorities, a comparison between customs administrations' import data and tax authorities' purchases data could theoretically result in the detection of undeclared or misdeclared taxation sources for both parties.

It is important to note, however, that information exchange between customs administrations and tax authorities may not be mutually beneficial. Tax authorities can squarely benefit from customs' trade data because trade data are compiled on a trade transaction basis: it is easy for tax authorities to identify which import or export transactions are not reported as purchases or sales by comparing tax payers (traders)' tax return documents and customs trade data.

[16] The WCO categorizes 179 member Customs administrations into three groups according to their organization types: ministry department type, independent agency type, and revenue authority type. Each type accounts for 45%, 28.3%, and 25% of 179 Customs administrations respectively (WCO 2015).

However, tax information does not necessarily serve customs administrations in the detection of illicit trade because electronically sharable tax information is usually maintained per business unit and includes aggregate quarterly sales and purchases figures for each business, and no information on individual sales/purchases[17]. Thus, customs administrations need to receive additional specific information from tax authorities in order to identify whether there are undeclared imports (exports) among reported purchases (sales). In other words, electronically sharable tax information is at an aggregate level for customs administrations, even information pertaining to individual businesses. It could be useful in gauging each trader's business transaction volume during certain assessment periods, but it is less useful in the detection of illicit trade transactions, as illustrated in the experiences of the Finnish and Korean customs administrations.

Finnish customs and the Finnish tax authority exchange information from import / export declarations and VAT recapitulative statements. Unlike import / export declarations which are maintained on a transactional basis, VAT recapitulative statements include information on the total supplies to other tax payers on quarterly basis. Analyzing each declaration using VAT recapitulative statements does not automatically lead to the detection of VAT fraud cases but is useful in identifying abnormal transactions. The Korea Customs Service (KCS) also regularly exchanges information on taxation sources, such as trade transactions and quarterly purchases and sales of traders, with tax authorities. The Korean example demonstrates that the introduction of automated systems is important to customs and tax authorities in exchanging information on taxation sources because the electronic recording of traders' trade activities and systematic management of them are essential in identifying relevant data and collecting such data from the other party. The experiences of Finish and Korea customs suggest that the exchange of information on taxation sources serves as a reference point to narrow down investigative targets rather than a guarantee of the detection of evasion of customs duties and taxes.

Although there is a general notion that from the perspective of customs administrations, it is difficult to expect exchange of information with tax authorities to result in tangible outcomes, customs administrations can benefit from detailed transactional information from tax authorities, especially with respect to taxing transfer pricing. Customs administrations and tax authorities address the same taxation target - transfer prices of MNCs, and have the same goal – the collection of more tax – but each approaches the issue from a different perspective. Customs administrations concentrate on importers' undervaluation, whereas tax authorities zero in on MNCs' overvaluation (Blouin et al. 2012).

[17] Tax authorities with electronic tax invoice systems maintain specific sales and purchases data at their database and can examine each sale and purchase transaction of individual tax payers without visiting tax payers' offices. However, it is dubious whether the tax authorities are willing to share the data with customs administrations.

Trade taxes (e.g., customs duties and import VAT) are imposed on the values of the goods, whereas corporate income tax is levied on net profit – the difference between sales and purchases (costs) – and the more costs, the less tax payment. Some MNCs report two different transfer prices[18] to customs administrations and tax authorities in order to minimize their tax payment. A comparison of MNCs' imports and purchases data for a particular commodity helps customs administrations and tax authorities to identify decoupled transfer prices. The decoupled transfer prices are likely to result in the detection of either customs duty evasion or corporate income tax evasion, although customs administrations and tax authorities need to coordinate their respective audits. The WCO and the OECD have engaged in a cooperative endeavor[19] to harmonize customs valuation and taxation on transfer pricing (Ping & Silberztein 2007).

In addition to sharing ordinary trade data, customs administrations can help tax authorities to detect cross-border tax evasion by sharing export and import declarations pertaining to the means of payment (e.g., cash). Some residents may declare their exports of cash to customs when leaving for other countries and purchase immobile assets overseas with the exported cash without reporting these assets to tax authorities of residence countries; some residents may declare their imports of cash earned overseas to customs, not reporting the income to tax authorities. Thus, if customs administrations share export or import declarations of monetary instruments with tax authorities, tax authorities can detect unreported cash-based incomes and assets. Furthermore, exchange of cash export/import declarations between customs administrations can enhance tax authorities' ability to detect unreported cash-based incomes and assets. In other words, when some residents declare their cash exports to customs of departure countries but not to customs of arrival countries, then tax authorities of residence (arrival) countries have little chance of discovering unreported cash-based incomes and assets. However, exchange of information on cash export/import declarations between customs administrations can make a difference in the detection of unreported cash-based incomes and assets (Han 2010).

Customs administrations can benefit from tax information not only in the detection of illicit trade but also in the collection of unpaid trade taxes. Customs administrations have difficulties in dealing with traders' default on tax payment because many administrations do not have the requisite information on traders' incomes and assets which could enable them to enforce payment on trade taxes. Taking advantage of customs administrations' lack of relevant information, traders can continue with their domestic businesses even if they default.

Information exchange could prove beneficial for customs administrations in these instances and help to ensure the recovery of unpaid trade taxes from traders,

[18] According to the OECD and the WTO guidelines concerning transfer pricing, transfer prices used for Customs duties and corporate income tax do not need to be identical to be consistent (Blouin et al. 2012).

[19] The WCO and the OECD had two joint conferences to seek to harmonize two different approaches in Belgium in 2006 and 2007 and two joint workshops to train Customs officers and tax officers about transfer pricing in Korea in 2012 and South Africa in 2013.

leveraging tax information including traders' incomes, assets, and domestic business transactions.

Exchange of information between customs administrations and tax authorities covers not only taxation sources, such as trade transactions, purchases, sales, incomes, and assets, but also investigative cases. Customs administrations and tax authorities can encounter the other party's enforcement targets, while examining or investigating their own enforcement targets. Unlike French customs and tax authorities that have an obligation to inform the other party of any suspicious cases that they encounter while conducting examinations for their own purposes, most customs administrations and tax authorities seem to hesitate to share with the other party their findings related to the other party under the pretext of protection of the privacy of traders or tax payers and of respect for the other party's turf. However, information on investigative cases is more useful and efficient than that on taxation sources in the detection of their enforcement targets. For instance, in Finland, prior to exchanging information on investigative cases between customs administrations and tax authorities, assessment on illegal and informal economies is made by the Gray Economy Information Unit of Finnish tax authority in consultation with Finnish customs in order to better aim to enforcement targets. In the course of conducting surveys on the grey economy and developing compliance reports of suspicious tax payers, the unit collects information about suspicious individuals from the tax authority, customs, and pension service. In other European countries, customs administration's criminal investigation unit and tax administration's VAT Anti Fraud Unit regularly exchange intelligence and early warnings on VAT returns and conduct joint operations in order to tackle missing trader inter-community (MTIC) fraud cases. In Korea, investigative information exchange between the customs administration and tax authority is concentrated on cross-border tax evasion. Whereas the customs administration informs the tax authority of cases where evasion of corporate income tax is suspected, while investigating flight of capital overseas and money laundering, the tax authority hands over the cases that are related to money laundering and capital flight uncovered during the investigation of cross-border tax evasion to the customs administration.

4. CONCLUSION

Although it manifests itself in a different manner, tax evasion is as firmly embedded in cross-border trade as it is in cross-border economic activities, such as saving and investing. Illicit trade which exploits the disconnected trade data flows between export countries and import countries has posed a serious threat to the tax revenues of many developing and some developed countries which are dependent on international trade. Even if the proportion of customs duties in the governments' coffers has dramatically decreased across the world, the importance of trade taxes should not be underestimated especially in developing countries. Many developing countries have struggled in obtaining as much tax revenue from income taxes and domestic VAT as developed countries.

That is because not only developing countries' domestic economies are not big enough to produce sufficient income taxes and domestic VAT but also income taxes and

domestic VAT are characterized as hard-to-collect taxes which require modernized tax examination and collection systems, compared to trade taxes collected at borders, which are called easy-to-collect taxes (Aizenman & Jinjarak 2009; Besley & Persson 2014). Trade taxes have greatly contributed to supplying revenue for development of domestic economies and modernized tax collection systems. However, developing countries is fraught with informal economies; cross-border trade also suffers from informality. Thus, customs administrations of developing countries attend to tax revenue collection involving cross-border trade; one of tools and methods that customs administrations can employ with little cost is exchange of information. The global customs community should seek exchange of information to come into play in a more systematic manner within the community. Thus, recent initiatives by the G20 Leaders and the OECD, such as its multilateral automatic tax information exchange initiative, have significant implications for customs administrations in identifying elusive tax bases and combating illicit trade. The fact that an exchange mechanism, such as tax information exchange, already exists within tax administrations might galvanize customs administrations into action and lead to the resumption of discussions regarding customs information exchange.

On the other hand, the global customs community, taking into account the challenging reality of customs information exchange, needs to examine an alternative information source which they can leverage in the combat against illicit trade and even money laundering - trade payment data, while striving for customs information exchange. Customs administrations have conventionally dealt with the movement of goods but have somewhat ignored the movement of trade payments. Even if trade data exchange is enforced between customs administrations as tax information exchange is between tax authorities, it may not result in the detection of illicit trade. That is because trade data exchange is based on the misleading assumption that export declarations are more accurate than import declarations. However, given the fact that customs authorities focus more on import declarations than export declarations, the accuracy of export declarations is of little consequence for customs administrations. To this day, only a small number of customs administrations have switched their audit focus from the movement of goods to the direction in which payment flows. This methodology, examining both the flow of payment and goods, can lead to the discovery of important indicators in the detection of illicit trade transactions (Table 3). In particular, it is important to cross-reference customs declarations and corresponding foreign exchange transactions for trade payment in a regularly and systematic manner. For this type of risk analysis, it is necessary to obtain foreign exchange transactions data from the central banks without the judiciary's intervention because foreign exchange transactions data are not evidence to prove illegality in cross-border trade but essential information leading to detection of high-risk transactions.

Table 3
Cross-referencing customs declarations and foreign exchange transactions

Player	Symptom	Diagnosis	Possible offence
Importer	Value declared < Value paid	Undervaluation	Evasion of trade taxes; capital flight
	Value declared > Value paid	Overvaluation	Evasion of corporate income tax; embezzlement of fund of domestic buyers (e.g., government)
Exporter	Value declared < Value received	Undervaluation	Evasion of corporate income tax
	Value declared > Value received	Overvaluation	export subsidies fraud; capital flight

Source: the authors

On top of making use of foreign exchange transactions data obtained from central banks for risk analysis, customs administrations may need to consider adopting a trade payment declaration scheme whereby traders report to customs administrations their foreign exchange transactions for trade payment regularly. In other words, in addition to the current system whereby traders submit their customs declarations whenever import and export consignments are to be cleared, traders periodically (e.g., twice a year) submit trade payment declarations to customs administrations. Trade payment declarations are anticipated to be useful given that as foreign exchange transactions data from the central banks merely rely on traders' declarations to banks, the data from the central banks do not reflect complex and flexible settlement methods between importers and exporters (e.g., setoff). In particular, this scheme can give traders a chance of explaining complex relationships between the flow of goods and the flow of money in their cross-border trade transactions. Thus, this scheme not only assists customs administrations to detect anomalies in cross-border trade but also help traders self-regulate their own cross-border transactions. Information exchange practices introduced in this paper are just examples from a few customs administrations. There must be better practices to tackle cross-border customs fraud and tax evasion. The potential and usefulness of information exchange are dependent upon not only policy-level endeavor of customs administrations but also individual officers' creativity and professional perseverance in disclosing tax evasion and avoidance.

REFERENCES

Aizenman, J & Jinjarak, Y 2009, 'Globalization and Developing Countries: A Shrinking Tax Base?' Journal of Development Studies, vol. 45, no. 5, pp. 653-71.

Avi-Yonah, R 2000, Globalization, 'Tax Competition, and the Fiscal Crisis of the Welfare State', Harvard Law Review, vol. 113, no. 7, pp. 1573-676.

Besley, T & Persson, T 2014, 'Why Do Developing Countries Tax So Little?' Journal of Economic Perspectives, vol. 28, no. 5, pp. 99-120.

Blouin, J, Robinson, L, & Seidman, J 2012, 'Conflicting Transfer Pricing Incentives and the Role of Coordination', Tuck School of Business Working Paper, 2010-74.

Brauner, Y 2014, 'What the BEPS?,' Florida Tax Review, vol. 16, no. 2, pp. 55-115.

Buettner, T & Wamser, G 2013, 'Internal Debt and Multinational Profit Shifting: Empirical Evidence from Firm-Level Panel Data', National Tax Journal, vol. 66, no. 1, pp. 63-96.

Cameron, D 2013, 'David Cameron: A British-American Tax and Trade Agenda', The Wall Street Journal, 12, May.

Clausing, K 2006, 'International Tax Avoidance and U.S. International Trade', National Tax Journal, vol. 59, no. 2, pp. 269-87.

Crandall, W 2010, Revenue Administration: Autonomy in Tax Administration and the Revenue Authority Model, IMF, Washington D.C.

Dharmapala, D 2008, 'What Problems and Opportunities are Created by Tax Havens?', Oxford Review of Economic Policy, vol. 24, no. 4, pp. 661-79.

European Commission (EC) 2013, Automatic Exchange of Information: Frequently Asked Questions, retrieved from http://europa.eu/rapid/press-release_MEMO-13-533_en.pdf.

Genschel, P & Schwarz, P 2011, 'State of the Art, Tax competition: a literature review', Socio-Economic Review, vol. 9, pp. 339-70.

Goorman, A and De Wulf, L 2005, Customs Valuation in Developing Countries and the World Trade Organization Valuation Rules. In: L. De Wulf and J. Sokol (eds.), Customs Modernization Handbook (pp. 155-82), World Bank, Washington D.C.

Han, C 2010, Korea - U.S. Cooperation Against Bulk Cash Smuggling. Washington D.C.: Brookings. Retrieved from http://www.brookings.edu/~/media/research/files/papers/2010/12/07%20us%20korea%20smuggling%20han/1207_us_korea_smuggling_han.pdf

Hines, J. Jr. 2010, 'Treasure Islands', Journal of Economic Perspectives, vol. 24, no. 4, pp. 103-26.

Johannesen, N. and Zucman, G. (2014). 'The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown', American Economic Journal: Economic Policy, vol. 6, no, 1, pp. 65-91.

Keen, M & Ligthart, J 2006, 'Information Sharing and International Taxation: A Primer', International Tax and Public Finance, vol. 13, no. 1, pp. 81-110.

Keen, M & Simone, A 2004, 'Tax Policy in Developing Countries: Some Lessons from the 1990s and Some Challenges Ahead' In: B. Clements, S. Gupta, & G. Inchauste (eds.), Helping Countries Develop: The Role of Fiscal Policy (pp. 302-52), IMF, Washington D.C.

Nitsch, V 2012, 'Trade Mispricing and Illicit Flows', In Peter Reuter (eds), Draining Development? Controlling Flows of Illicit Funds from Developing Countries, World Bank, Washington D.C., pp. 309-34.

Nicodeme, G 2009, 'On Recent Developments in Fighting Harmful Tax Practices', National Tax Journal, vol. 62, no. 4, pp. 755-71.

Organization for Economic Cooperation and Development (OECD) 2013a, Multilateral Convention on Mutual Administrative Assistance in Tax Matters: Information Brief, OECD, Paris.

Organization for Economic Cooperation and Development (OECD) 2013b, A Step Change in Tax Transparency: OECD Report for the G8 Summit, Lough Erne, Enniskillen, June 2013, OECD, Paris.

Organization for Economic Cooperation and Development (OECD) 2012, Automatic Exchange of Information: What It is, How It Works, Benefits, What Remains to be Done, OECD, Paris.

Owens, J & Bennett, M 2008, OECD Model Tax Convention: Why It Works. OECD Observer, 269, OECD, Paris.

O'Shea, T 2010, 'EU Adopts Recovery of Taxes Directive' Tax Notes International, vol. 58, no. 6, pp. 475-8.

Palan, R 2010, ‘Tax Havens, the Crisis of 2007 and Financial Regulations’, The European Financial Review, October 15.

Ping, L & Silberztein, C 2007, ‘Transfer pricing, customs duties and VAT rules: Can we bridge the gap?’ World Commerce Review, vol. 1, no. 1, pp. 36-8.

Scott, M 2012, ‘Tax Haven Crackdown Creates Opportunities for Bankers’, The New York Times, 5, April.

Tanzi, V & Zee, H 2010, ‘Taxation in a Borderless World: The Role of Information Exchange’, INTERTAX, vol. 28, no. 2, pp. 58-63.

The Economist 2013, ‘The G8 Agenda: The Transparency Summit’, The Economist, 15, June.

Thuronyi, V 2001, ‘International Tax Cooperation and Multilateral Treaty’, Brooklyn Journal of International Law, vol. 16, no. 4, pp. 1641-81.

Tobin, G & Walsh, K 2013, ‘What Makes a Country a Tax Haven? An Assessment of International Standards Shows Why Ireland is Not a Tax Haven’, The Economic and Social Review, vol. 44, no. 3, pp. 401-24.

World Customs Organization (WCO) 2015, WCO Annual Report 2014-2015, WCO, Brussels.

World Customs Organization (WCO) 2003, Technical Committee on Customs Valuation Response to the Terms of Reference for the Work of the Technical Committee on Customs Valuation in Connection with Concerns on the Accuracy of the Declared Value, VT0330E1, WCO, Brussels.

Zdanowicz, J 2009, Trade-Based Money Laundering and Terrorist Financing. Review of Law & Economics, vol. 5, no. 2, pp. 855-78.

Zucman, G 2014, ‘Taxing across Borders: Tracking Personal Wealth and Cooperate Profits’, Journal of Economic Perspective, vol. 28, no. 4, pp. 121-48.

My CIAT Services

Inter-American Center of Tax Administrations

Tax administration official:

Find out about the benefits of registering in My CIAT.

When registering in My CIAT, you will:

- Receive the e-CIAT Newsletter and the Tax News Alert;
- Receive announcements of the innovations published in our Portal;
- Have access to all the information and documents available at CIAT's Web Site.

If you do not register in My CIAT, you will not have access to the restricted areas of the CIAT Portal.

Take advantage of registering in My CIAT.

Register Now!

Inter-American Center of Tax Administrations
Executive Secretariat
P.O. Box 0834-02129, Panama, Republic of Panama
E-Mail: ciat@ciat.org
Web Site: http://www.ciat.org
Tels.: (0507): 265-5995, 265-5996
Fax: (0507): 264-4926