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Introduction

CIAT Tax Thematic Series

In an effort to provide an ever better and highly qualified tax information service to its member countries, the Inter-American Center of Tax Administrations hereby presents the seventh issue of the CIAT Tax Thematic Series.

The purpose of this series is to disseminate relevant information on specific taxation issues to support the research and study work carried out by the tax administrations of the CIAT member countries.

The bibliographical material of this seventh issue is devoted to "Tax Evasion". The material gathered includes studies and papers prepared by technical officials for presentation either at the general assemblies or technical conferences, essays, research scholarships and articles published in the tax administration review, among others.

To speed up the search and recovery of information a general table of contents and index is presented for each paper. The documents that are part of this issue are available in the CIAT Virtual Library and web page: www.ciat.org.

Through this new documentary contribution CIAT, hopes to disseminate the bibliographical material existing in the Jorge Eduardo Corradine Library, for the benefit of the tax administrations.



Measurement



Tax Evasion Measurement: The Uruguayan Case

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Gustavo González
(Uruguay)

1. INTRODUCTION

Within the frame of the General Revenue Office's mission of "assuring the collection of the State's resources through the effective application of the regulations on internal taxes that fall within its competence, by promoting the voluntary compliance of taxpayers"¹, the fight against tax fraud and default is among the objectives presented.

To this end it is necessary to know the magnitude of tax default, which is achieved by comparing the potential collection against the actual collection, thus obtaining the tax evasion rate.

By potential collection it is understood the collection that could be actually obtained if all legally bound taxpayers declared the total taxes assessed in their activity. This concept is exclusive of tax deductions or exemptions that certain taxpayers may enjoy, which are considered as components of tax expenditure.

The question remains being how the potential collection of a tax may be measured.

On this regard, the methods mostly used by tax analysts are two: i) direct and ii) indirect.

The direct method consists in measuring evasion through the examinations performed on a random sample of individuals or corporations, to then extrapolate the results to the total population.

The indirect method or theoretic potential consists in the estimation of the potential collection through the use of external data sources.

Both methods present advantages and disadvantages, which should be known before making a choice in order to achieve the most adequate results.

The direct method requires that the sample being used should be statistically representative, and the results will depend on the quality of the conducted audits. Alternatively, in the indirect method the quality of the results will largely depend on the reliability of the estimations provided by the National Account System and, additionally, in the case of the IRPF, the reliability of Home Surveys.

Once the method is defined and the sum or the evasion rate is obtained, this information is of vital importance for tax administrations, for it allows them to better target the resources allocated for examining certain taxes or activity sectors, and thus achieve efficiency in fulfilling their objectives and missions.

2. THE METHOD USED IN URUGUAY

The General Revenue Office (DGI) has estimated the evasion of the value-added tax (VAT), the tax on industry and trade income (IRIC) and the tax on economic activity income (IRAE), and the tax on individuals' income (IRPF), using the indirect method in all cases. The reason for choosing such method is because the direct method demands a greater amount of resources, whether with relation to the design of representative samples or the examination itself. In general, ordinary examinations entail a biased selection that may deviate from what would be desirable to attain from the representative sample.

2.1. The VAT case

The estimations of VAT evasion held by the administration are based on the estimation of the theoretical base of the tax as provided from the National Account System.

¹ Decree 192/006 – Mission, objectives, commitments and organizational structure.

The potential collection is determined by estimating the non-deductible VAT, which originates in the final consumption of taxed goods and services, in the purchase of taxed goods and services used as intermediate inputs or investment goods for the production of tax-exempted goods and services.

The main components that originate non-deductible VAT payments are:

- The final consumption of taxed goods and services by homes
- The Government's consumption
- The Government's investment
- The taxed intermediate consumption used to produce tax-exempted and export goods and services
- The investment in taxed goods intended to produce tax-exempted and export goods and services

The potential collection of each component is equal to its taxable base times the average rate:

Potential VAT collection per component $_i$ = Component's base $_i$ x average rate $_i$

The aggregate of each component considered results in the total potential VAT collection:

Potential VAT collection = \sum potential VAT collection per component $_i$

With the resulting tax evasion rate:

Evasion = Potential VAT collection – Gross effective VAT collection

The information requirements necessary to estimate the collection of the above mentioned components are detailed².

To quantify the **VAT generated from home consumption**, the following variables were considered:

Variables	Data	Information sources
Final home consumption expenditure	External	Banco Central del Uruguay (BCU)
Composition of taxed and tax-exempted goods and services expenditure	External	National Institute of Statistics (INE)
Expenditure of goods and services purchased from small companies and taxpayers in the self-employed workers scheme	Internal research	General Income Office (DGI)
Uruguayans' consumption expenditure abroad	External	BCU
Foreigners' consumption expenditure in Uruguay	External	BCU
Average VAT rate	Internal research	DGI, INE, Ministry of Tourism and Sports (MINTUR)

Based on the final private consumption expenditure of National Accounts, the potential taxable base was estimated for each year.

This rate required some adjustments as a result of considering tourists' expenditure in the country and a discount of Uruguayan homes' expenditure abroad; and also small-sized companies and self-employed workers' scheme taxpayers who do not generate the VAT from their sales but from their purchases.

Once the components of the home consumption base were defined, the effective average rate of the VAT applicable to each of them in each year of the period was determined, to later estimate the potential collection of this tax.

² For more details on the measurement per component, see Annex 1.

VAT generated from Government's consumption

The estimation of the VAT generated from the purchase of goods and services for Government consumption was conducted based on the following variables:

Variables	Data	Information sources
Intermediate consumption by Government	External	BCU
Operating expenses of the Central Administration	External	General Government Accountability Office (CGN)
Average VAT rate	Own research	CGN, DGI

The component considered in the Government's consumption expenditure³ was the intermediate consumption, because it is representative of the VAT-generated expenditure.

To the extent that the information in National Accounts gives no annual detail of the structure of this intermediate consumption, the VAT average rate applicable each year to the Government's consumption was determined from the composition of the operating expenditure of the Central Administration⁴ (with the rate corresponding to each expenditure item).

VAT generated from Government's investment

In the case of the Government's investment, the estimation of potential generated VAT was conducted using the following variables:

Variables	Data	Information sources
Gross formation of Government's fixed capital	External	BCU, public companies
Investment expenditure of the Central Administration	External	CGN
Government's imports of capital goods	External	National Customs office (DNA)
Average VAT rate	Own research	CGN, DGI

To determine the VAT potential base associated with the Government's investment, the value of the gross formation of fixed capital (FBKF, in Spanish) of the Public Sector of National Accounts was used. Since this information includes public companies, the investment performed by the latter⁵ was discounted, calculated from the Charts of Property available for Use included in their Balance Sheets.

The VAT average rate applicable to this investment was calculated based on the composition of the investment expenditure of the Central Administration, obtained from the Accountability and Budget Execution Balance report, which presents the investment amounts broken down by program-project and by expenditure item.

³ Includes: the Central Government, Departmental and Social Security Governments (only for the administration services of the pension system). The institutional agent Government is exclusive of public companies, which are considered private agents.

⁴ The Central Administration includes the following institutional units: the Executive Branch, the Legislative Branch, the Judicial Branch, the Government Accounting Office, the Court of Elections, the Administrative Litigation Court, the National Administration of Public Education, Universidad de la República and the Child and Adolescent Institute of Uruguay.

⁵ The public companies considered were: ANCAP, ANTEL, ANP, OSE and UTE.

VAT generated from the intermediate consumption used to produce tax-exempted and export goods and services

Pursuant to the provisions established in the effective legislation, the VAT included in the purchase of goods and services made by companies constitutes deductible VAT if the goods and services are used for resale or manufacture of taxed products. Where produced goods and services are intended for export, the company may opt between discounting the VAT of purchases associated with the payment of other taxes (including the VAT payable for market sales, if the company also produces goods for the local market⁶) and requesting credit certificates⁷. Alternatively, the VAT included in the purchases of goods and services intended to manufacture tax-exempted products cannot be discounted.

To the extent that the collection considered in this paper is gross, the VAT associated with purchases used to produce tax-exempted goods and services as well as the VAT related to export operations were treated as potentially non-deductible VAT.

The estimation of the potential VAT associated with the intermediate consumption used in the production of tax-exempted goods and services or those intended for the external market was performed using the following variables:

Variables	Data	Information sources
Intermediate consumption per economic activity type	Own research	BCU, DGI, DNA
Exports by economic activity type	External	DNA
Percentage of tax-exempted sales by economic activity type	Own research	DGI
Average VAT rate	Own research	BCU, DGI

The determination of the potential base of this non-deductible VAT component required to establish firstly what proportion of the intermediate consumption of the different sectors was used each year in the production of goods and services intended for the local market, and what proportion was allocated to produce export goods. These percentages were applied to the data on intermediate consumption by activity class as obtained from the National Accounts⁸, thus determining the amount used in the production of goods and services targeted at the local market and the amount used in manufacturing export products.

Once the intermediate consumption associated with the production targeted at the local market was defined, the percentage used each year in the manufacture of tax-exempted products was established.

⁶ In this case, the company may discount the VAT of purchases from the VAT of sales corresponding to the operations performed in the local market and use the excess, if any, to pay other taxes or future year taxes (in the case such credit is not used up within the relevant period).

⁷ The credit certificates may be used by the company to pay taxes included in the bills of their goods and service providers, provided that the same are a direct integral part of the cost of the exported goods (in this case, the company pays to its provider the net amount of the bill and delivers the requested credit certificates to the DGI).

⁸ Like the other National Account variables, the amounts of intermediate consumption estimated by the BCU include the VAT, so it was necessary to calculate for each year the corresponding non-VAT amounts using the respective sector average rates of this tax.

VAT generated from the investment targeted at producing tax-exempted and export goods and services

The last component that is considered as a potential base of non-deductible VAT was the taxed private investment⁹ intended to produce tax-exempted and export goods and services. Its estimation drew on the following variables:

Variables	Data	Information sources
Fixed capital gross formation in the private sector	External	BCU, INE, Ministry of Livestock, Agriculture and Fishery (MGAP)
Fixed capital gross formation of public companies	External	Public companies
Fixed capital gross formation by activity class	Own research	BCU, DGI, INE, MGAP
Imports of capital goods by the private sector	External	DNA
VAT average rate	Own research	BCU, DGI

Since the FBKF data from the National Accounts present a greater aggregation than required, the investment amount contributed by each sector had to be determined by resorting to additional information sources, regrouping activities under new categories¹⁰.

Sector	Source	Available period
Agriculture and livestock	OPYPA - MGAP	2000-2006 ¹¹
Manufacturing industries	INE	2001, 2003-2005
Electricity, gas and water	INE	2001, 2003-2005
Trade, restaurants and hotels	INE	2001, 2003-2005
Transportation, storage and communications	INE	2001, 2003-2005
Others	Own research	-

As it happens with public investment, part of the private investment benefits from tax exemptions¹².

After obtaining the taxed investment of each activity sector, the portion used in producing goods intended for the local market was determined, as well as the portion used in manufacturing export products.

Subsequently, from the investment amount allocated by each sector to the production of goods and services for the local market, the portion of such investment used each year in the manufacture of tax-exempted products was determined.

Once the potential collection per component is obtained, it is compared against the effective collection, considering that the local VAT liquidation is carried out in the month following the month in which the originating act takes place; therefore, the effective collection should be considered as accrued.

⁹ Public companies' investments are included in this category.

¹⁰ The need to regroup the sectors originated in the lack of available information for all activity classes.

¹¹ The data for 2006 is preliminary, and data for 2007 and 2008 are our own estimation.

¹² The Act 16.906, effective since 1998, contains rules relating to the declaration of interest of some investments performed in the national territory by both national and foreign operators who are engaged in industrial or agriculture and livestock activities. These investments comprise: the acquisition of personal property directly allocated to the production cycle, the purchase of equipment for electronic data processing, fixed improvements intended for industrial and agriculture-livestock activities, and some intangible goods, among others.

2.2 The case of the tax on industry and trade income (IRIC) or tax on economic activity income (IRAE).

Using the indirect method for the study of the income tax evasion also implies obtaining the potential collection thereof. To this end, the tax income must be approximated to the relevant macroeconomic aggregate, which in this case is the Gross Operating Surplus (EEB, in Spanish), that is, the balance corresponding to the income generating account resulting from the National Account System (the Gross Added Value minus Remunerations minus taxes net of subsidies).

The taxable amount derives from the legal regulation, the maximum being between the taxable income, if positive, and zero, in the event of loss.

$$MI = \text{Maximum} \{RF, 0\}$$

As approximation to the taxable amount, the operating surplus (EEB) is used; this results from the difference or balance in the income generating account of the National Account System. The same is the Gross Added Value (VAB, in Spanish), which is defined as the Gross Production Value (VBP, in Spanish) minus the Intermediate Consumption (CI, in Spanish), after remunerations (RA, in Spanish) are deducted, minus taxes on production net of subsidies (T-S).

$$EEB = VBP - CI - RA - (T-S)$$

The taxable amount is determined using the EEB, along with the relevant adjustments¹³, which results in:

$$MI = EE - RE (-/+) AF - GNA + DI$$

The tax-exempted income (RE, in Spanish) considered is, among others:

- Free-trade zone users
- wood producers
- taxpayers covered in Letter E
- self-employed workers' scheme taxpayers
- taxpayers of other taxes not included in IRIC/IRAE

The Fiscal Adjustments (AF, in Spanish) correspond to the fiscal adjustments that the tax regulation requires to be made in order to determine the taxable income. Likewise, non-admitted expenses (GNA, in Spanish) are actual expenses incurred (which are part of the EEB) but the deduction of which is not allowed to determine the taxable income.

Under the regulation, increased deductions (DI, in Spanish) are defined as certain expenses that may be computed by more than one time their actual amount, and are:

- expenses for training staff in areas considered a priority
- expenses for payment of fees to technicians for their assistance in areas considered a priority
- expenses incurred by companies to obtain the certification under internationally admitted quality standards
- expenses incurred to obtain accreditation of laboratory trials
- expenses incurred in the purchase of labeled seeds by agriculture producers
- expenses for incorporating animal genetic material
- expenses for software services rendered by those who are subject to this tax

¹³ For a greater detail of equations, see Annex 2.

Once the taxable amount is obtained, it is multiplied by the tax rate, resulting in the potential collection. To calculate the evasion amount, the potential collection is compared against the effective collection, the latter being that declared by taxpayers.

Effective IRIC/IRAE= declared IRIC/IRAE

The tax evasion rate,

$$Tasa\ de\ evasión_t = \frac{(IRICP_t - IRICE_t)}{IRICP_t} = \frac{Evasión\ IRIC_t}{IRICP_t}$$

$$Tasa\ de\ evasión_t = \frac{(IRAEP_t - IRAEE_t)}{IRAEP_t} = \frac{Evasión\ IRAE_t}{IRAEP_t}$$

where IRICP and IRAEP pertain to the *potential* collection of IRIC and IRAE, respectively, while IRICE and IRAEE pertain to the *effective* collection of IRIC and IRAE, respectively.

The information sources required to perform the estimation were both internal of the administration itself and external.

- Internal
 - Taxpayers' returns, CEDE and NO CEDE
 - Tax returns of agents responsible for withholdings
 - Payment of taxes by taxpayers
- External
 - EEB obtained from national accounts of the National Account System 1993 (BCU)
 - Economic Activity Census, 1998 (INE)
 - Economic Activity Survey, 2002, 2003, 2004, 2005, 2007 (INE)

2.3. The case of the tax on individuals' income (IRPF)

The Uruguayan IRPF has been recently created, and its implementation began with the coming into force of the New Tax System in July 2007. As noted in the introductory summary of this document, the process of estimating the IRPF evasion is in its early stages. Firstly, the analysis of the category II of the tax is presented, which comprises work income and, within this category, the study focuses on the income deriving from salaried work relationships.

The consulted sources comprise the DGI's databases (which receive data from collaborative entities and the taxpayers' returns), the Ongoing Home Survey (ECH 2008) published by the INE and the data from the National Accounts published by the BCU.

The purpose of arriving at a potential collection of the tax based on ongoing surveys has the advantage of following up the evasion calculation for the subsequent years, because these surveys are performed continuously and will allow making an adequate calculation of the current design of computable income for the tax, as well as having the possibility of changing parameters resulting in modifications in the design or the mechanics of the tax in the future.

A two-stage calculation proceeding is followed: a first stage for calculating evasion resulting from the informal economy, understatements or tax fraud; and a second stage for calculating evasion from default or omission.

The first stage consists of two alternative mechanisms, the first one concerning the nominalization of personal income comprised in the ECH, the adjustment thereof by way of a coefficient deriving from the existing income gap between the Survey and the National Accounts (as a way to detect any understatements in the Survey), in order to arrive at a calculation of a potential tax from the income declared in the Survey, adjusted as per the National Accounts.

The second mechanism consists in the distribution of the Survey income (without a previous adjustment for National Accounts) in deciles or bands, to then proceed to make an analogous calculation based on the income declared before the DGI, as a way to identify the tax evasion phenomenon by comparing both income distributions.¹⁴

Once both income structures (that corresponding to the ongoing survey base and that pertaining to DGI's statement base) are obtained, an effective average rate is calculated corresponding to each proposed band or decil. In this way, an effective average IRPF per band or decil is obtained, and by comparing both amounts, the average evasion can be calculated, which allows the later calculation of an evasion rate.¹⁵

Both mechanisms allow obtaining an estimation of the evasion resulting from the informal economy, understatements or tax fraud. The simultaneous utilization thereof allows making a contrast of the obtained results through one and the other, which results in an evaluation of their robustness.

The second stage is concerned with the estimation of evasion as a result of default or omission, through the comparison between the accrued tax (a calculation made from each person's income as it appears in the DGI's administrative records) and its comparison with the IRPF effectively paid in the relevant period.

By consolidating both facets of evasion (the one obtained through the first and the second stages), what is intended is to arrive at a global amount of IRPF evasion and its corresponding rate.

2.4. Limitations to the Theoretical Potential Method

The main limitation relates to the information sources. In the case of the data provided by the National Accounts, the primary characteristics that constitute limitations are:

- estimations are usually available one year later or more, which implies a great delay. In particular, the EEB is available by activity sector for the period 1997-2005, and the relevant publication for 2006 and 2007 is expected by April 2011.
- the most recently published National Accounts' figures are preliminary, and it should be stated that tax evasion measurement studies are sensitive to changes in these variables.
- if there is any error in the estimation, it is carried over to the tax evasion measurement.

In the case of the data deriving from the Ongoing Home Survey, some aspects could lead to estimation errors. Among the most relevant ones is the fact that the net income is surveyed, but not the gross income. The concept of net income is somewhat malleable in practice (net of social security contributions to the health insurance, but it may also be net of other items, such corporate shares or loans discounted

¹⁴ The identification of the "evasion" phenomenon through the detection of a disarrangement in the income declared to the DGI from the uppermost to the lowermost bands.

¹⁵ Evasion rate as a quotient between the average evasion and the potential average IRPF based on the ECH.

from the salary, etc.), which increases the probability of errors in the estimation of the gross or nominal income, which is the reference for calculating the IRPF.

It should be considered that despite the above stated limitations, the method is useful in that it allows determining the magnitude of the evasion and, most importantly, its evolution.

3. OBTAINED RESULTS AND DISSEMINATION

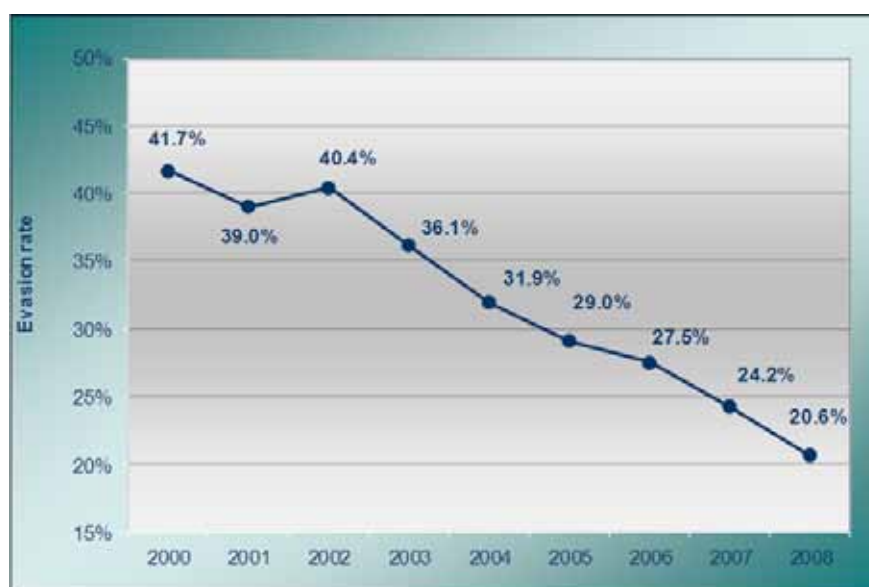
In the case of the VAT, there is a tax evasion rate series covering the period 2000 – 2008.

Year	VAT Collection*		Evasion*	Evasion in % PIB	Evasion rate
	Potential	Effective			
2000	33.154	19.335	13.818	5,0%	41,7%
2001	33.133	20.222	12.911	4,6%	39,0%
2002	35.285	21.023	14.262	4,9%	40,4%
2003	43.166	27.577	15.589	4,6%	36,1%
2004	52.354	35.658	16.696	4,3%	31,9%
2005	56.332	39.968	16.364	3,9%	29,0%
2006**	64.807	46.993	17.815	3,7%	27,5%
2007**	73.590	55.777	17.813	3,1%	24,2%
2008**	86.199	68.418	17.781	2,6%	20,6%

* Figures in millions of current pesos.

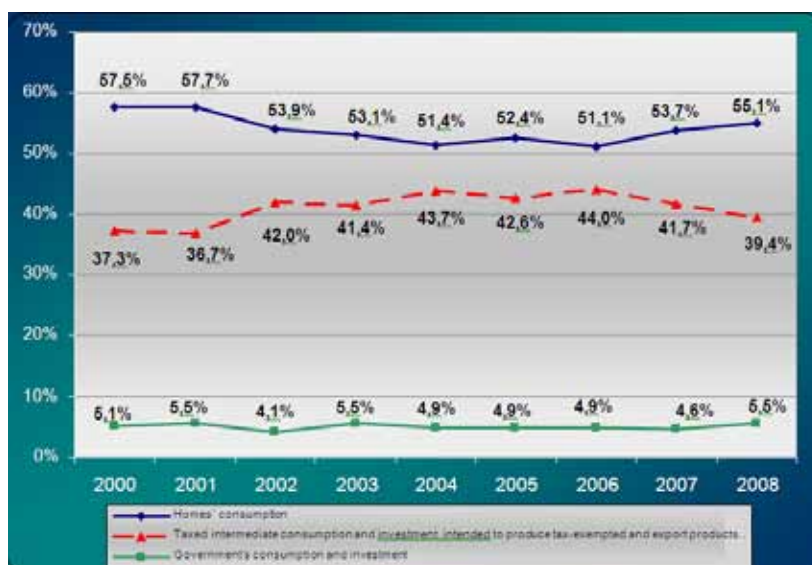
** Preliminary.

The indicator's evolution has been downwards since 2003, a trend that has been accentuated in the last two years of the series, recording a reduction of -25.0%. Considering the period as a whole, the evasion rate went down by -50.5%.



Upon analyzing the distribution of the potential VAT among the agents subject to the tax, we observe that during the period, on average, 53.7% of the potential collection corresponded to homes, 41.3%

corresponded to companies producing tax-exempted and export goods and services, and the remaining 5.0% to the Government.



The contribution made by the two components having greatest relative weight on the variation of the potential VAT shows that there is no predominance of any one of them: home consumption records the greatest contribution to such variation in four years of the period, whereas the contribution of intermediate consumption and investment taxed on companies intended for the production of tax-exempted and export goods constitutes the most significant in the rest of the years.

The variations observed in the evasion rate would be mainly attributable to the evolution of the *economic activity*, the *Tax Administration's management* and the changes in the *tax regulation* related to the tax.

The considerable increase in the evasion rate recorded in 2002 (3.7%) is mainly the result of the fall in the activity level, which may have been partly counteracted by the improvement in the DGI's management¹⁶. From 2003, the beginning and the subsequent firming up of the economic recovery, along with a continuous improvement in the TA's management allowed reducing the evasion indicator, which maintained the downward trend during the rest of the period.

In 2007 and 2008, the changes introduced by the New Tax System regarding the VAT regulation (modification of tax rates, as well as its bases, with the inclusion of new goods and services that used to be exempted and the elimination of COFIS), implied a tax sacrifice that accounted respectively for 2.4% and 2.3% of the effective VAT collection. In those same years, the collection attributable to a reduction in the evasion rate accounted respectively for 4.3% and 4.5% of the effective collection, and overcompensated for the fiscal sacrifice associated with the changes in the tax regulation.

This comparison does not purport to indicate that the reduction in the VAT rates (and its consequential tax sacrifice) was the reason for such compensation in tax collection by way of a fall in evasion. Evasion is associated with multiple factors and, under this particular circumstance, the economic activity and the efficiency in the DGI's management may presumably have exercised a greater impact. However, the comparison is useful to size up the economic importance of the reductions observed in evasion, and,

¹⁶ The improvement in DGI's management is measured through an efficiency index created for such purpose. The variation of this index was positive between 2002 and 2001, which would indicate that the Tax Administration contributed positively to the increase in collection, despite the recessionary scenario.

additionally, it points out at a virtuous cycle that is frequently highlighted in evasion theories: when the degree of taxpayer compliance is greater, tax collection can be sustained with lower tax rates.

In the case of **IRIC/IRAE**, an estimate was made for 2005, considering thirty-four sectors of the economic activity, which were taken from the opening presented by the Central Bank for the EEB. It should be noted that even though the publication of the National Account System is for 43 sectors, only those covered by the tax were considered.

These are:

- Mining and quarrying
- Manufacturing industries (23 industries)
- Power, gas, steam supply and water catchment and distribution
- Construction of buildings and other works
- Wholesale and retail trade
- Hotels and restaurants
- Transportation
- Mail and communications
- Financial brokerage
- Real estate activities
- Machinery and equipment rental, research and development activities

By applying the methodology explained in 2.2, the potential collection of the tax is obtained, which is compared against the effective collection. An estimation of tax evasion is contemplated from 2000 to 2008. But the data corresponding to the EEB by sector for the years 2006 through 2008 has not been published yet.

This is the reason that no results are presented until obtaining a series that may allow showing the trend recorded in the evasion rate over the years, and which may be apt to compare the consistency of the results on a sector level.

As for the **IRPF**, the results obtained so far are both preliminary and partial, and require subsequent processes of contrast and validation before considering their public dissemination. However, even under these circumstances, it is possible to clearly verify through these results that the tax evasion in salaried income is highly concentrated in the formal employment. Therefore, evasion in this section of the IRPF could be attributable to understatements in the formal employment payrolls and, to a much less extent, to informal employment¹⁷. The potential collection of the tax resulting from the informal employment (which is, by definition, evaded 100%) would have a minor share in the total of potential collection.

A highly significant salary gap is observed in the Uruguayan labor market between formal and informal employment, in favor of the former. The progressive structure of the IRPF, which implies increasing effective rates along the income gradation, translates this salary gap to even more distant taxation levels. Consequently, the result commented in the previous paragraph is consistent both with the reality of the Uruguayan labor market and the tax's design.

Lastly, regarding the **dissemination criteria**, the choice has been to disclose publicly the results once they have been duly validated from a technical viewpoint and a series thereof has been construed for a considerable period, which may allow observing the evasion evolution and its consistency with the evolution of its explanatory factors.

¹⁷ Exclusive of single owner informal jobs. It should be restated that this first study focuses on salaried income, that is, those originating in a contract job.

Within this frame, the results of VAT evasion have been presented on an annual basis since 2006, by means of press conferences performed with representatives of the Ministry of Economy and Finance and the General Revenue Office. In the case of the IRIC/IRAE and the IRPF, given the above mentioned technical reasons, the results obtained so far are not sufficient to consider their public disclosure.

4. CONCLUSIONS

Given the importance of tax resources in the State's fiscal policy, one of the objectives of the General Revenue Office is the fight against fraud and the consequential tax evasion.

In order to know the magnitude of the evaded amount, the same has been estimated for the Value-added Tax, and that of the Economic Activity Income Tax and the Individuals' Income Tax is now also being estimated.

For all the measurements, the method used has been the indirect one, which draws on external data sources. The main input is composed of the macroeconomic aggregates obtained from the National Account Systems. Specifically, in the case of the VAT, the private consumption, the Government's consumption, the Intermediate consumption, the Gross Formation of Fixed Capital are considered; in the case of the IRAE, the Gross Operating Surplus, and in the case of the IRPF, remunerations. By introducing some adjustments to this aggregations, the potential collection of the tax is obtained, which is compared against the effective collection, thus arriving at the evasion rate. In the case of the IRPF, the micro-data from the Ongoing Home Surveys are used as supplementary source.

The results of the VAT evasion rate for the period 2000 – 2008 show a downward trend, except for 2002, reaching a bottom of 20.6% in 2008. These results have been presented at a press conference by the authorities of the Ministry of Economy and Finance and the General Revenue Office.

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Annex 1: Potential collection of VAT by component

The main components that originate non-deductible VAT payments are:

- the final consumption by homes of taxed goods and services
- the Government's consumption
- the Government's investment
- the taxed intermediate consumption used to produce tax-exempt and export goods and services
- the investment in taxed goods intended to produce tax-exempt and export goods and services

Final consumption by homes of taxed goods and services:

$$IVACH = (GCFH - GCUE) \times t_{1a} + GCEU \times t_{1b} + IVAPEM$$

where:

<i>IVACH</i>	potential collection of VAT originating in home consumption ¹⁸
<i>GCFH</i>	expenditure of final consumption by homes
<i>GCUE</i>	expenditure of Uruguayans' consumption abroad
<i>GCEU</i>	expenditure of foreigners' consumption in Uruguay
<i>IVAPEM</i>	potential collection of VAT originating in purchases made by small companies and self-employed workers' scheme taxpayers
t_{1a}	average VAT rate of GCFH
t_{1b}	average VAT rate of GCEU

Government's consumption:

The amount of potential VAT collection by Government's consumption item was calculated as follows:

$$IVACG = GCIG \times t_2$$

where:

<i>IVACG</i>	potential VAT collection resulting from Government's consumption ¹⁹
<i>GCIG</i>	expenditure of Government's intermediate consumption
t_2	average VAT rate of GCIG

Government's investment:

The potential VAT generated by the Government's investments was estimated as follows:

$$IVAIG = IG \times t_3$$

18 Since the values estimated by the BCU include the VAT, the relevant non-VAT amounts were determined using the respective average rates of this tax. The calculation was as follows:

$Consumption\ without\ VAT = [VAT\ consumption\ inc / (1 + t_{media})]$, where t_{media} is the VAT applicable in each case.

19 Like in the case of home consumption, the values of the Government's intermediate consumption estimated by the BCU include the VAT, so the corresponding non-VAT amounts were calculated for each year using the respective average rates of this tax.

where:

IVA/IG	potential VAT collection deriving from the Government's investment ²⁰
IG	FBKF of Government net of tax-exempted imports
t_3	average VAT rate of the IG

Taxed intermediate consumption used to produce tax-exempted and export goods and services:

The calculation of the VAT potential base tied to the intermediate consumption used by each sector in the production of tax-exempted goods and services is summarized as follows:

$$CIE_i = [CI_i(1 - \alpha_i)]\beta_i$$

where:

CIE_i	intermediate consumption of activity class i intended for tax-exempted production
CI_i	intermediate consumption of activity class i
α_i	percentage of sales of activity class i intended for export
β_i	percentage of tax-exempted sales of activity class i

Alternatively, the VAT potential base associated in each sector with the intermediate consumption used to manufacture export products was calculated as follows:

$$CIEX_i = CI_i \times \alpha_i$$

where:

$CIEX_i$	intermediate consumption of activity class i intended for manufacture of export products
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The average VAT rates applicable to the potential bases of each sector were determined using the structure of the intermediate consumption of each activity class, as the same appears in the Offer and Utilization Chart prepared by the BCU for 1997 (COU97).

So, drawing on the potential bases and the average rates applicable to the different activity sectors, the collectible amount of VAT was calculated for each intermediate consumption item tied to the production of tax-exempted goods and services, as follows:

$$IVACIE_i = CIE_i \times t_{4i}$$

where:

$IVACIE_i$	potential VAT collection resulting from the intermediate consumption of sector i tied to the production of tax-exempted goods and services
t_{4i}	average VAT rate of intermediate consumption of sector i

²⁰ Also in this case, the amounts of FBKF of the Public Sector estimated by the BCU include the VAT, so the corresponding non-VAT amounts for each year required calculation, using the respective average rates of this tax.

In the case of the intermediate consumption tied to the production of export goods and services, the calculation was as follows:

$$IVACIEX_i = CIEX_i \times t_{4i}$$

where:

$IVACIEX_i$ potential VAT collection resulting from the intermediate consumption of sector i tied to the production of export goods and services
 t_{4i} average VAT rate of the intermediate consumption of sector i

Therefore, the total potential non-deductible VAT to be collected each year from the intermediate consumption of the sectors producing such tax-exempted (IVACIE) or export goods (IVACIEX) was obtained as follows:

$$IVACIE = \sum_i IVACIE_i$$

$$IVACIEX = \sum_i IVACIEX_i$$

Finally, the total non-deductible VAT tied to intermediate consumption (IVACI) results from:

$$IVACI = IVACIE + IVACIEX$$

Investment in taxed goods intended to produce tax-exempted and export goods and services

The calculation of the VAT potential base tied to the investment used by each sector in the production of tax-exempted goods and services is summarized as follows:

$$IPE_i = [FBKF_i(1 - \alpha'_i)]\beta'_i$$

where:

IPE_i FBKF net of tax-exempted imports, allocated per activity class i for tax-exempted production
 $FBKF_i$ FBKF of activity class i net of tax-exempted imports
 α'_i percentage of sales of activity class i intended for export
 β'_i percentage of tax-exempted sales of activity class i

Alternatively, the VAT potential base associated in each sector with the investment targeted at the manufacture of export goods and services was calculated as follows:

$$IPEX_i = FBKF_i \times \alpha'_i$$

where:

$IPEX_i$ FBKF net of tax-exempted imports, targeted by the activity class i at the production of export goods and services

The VAT rate applied to this investment was the base rate, to the extent that the goods involved are assessed at this rate.

Using the potential bases of the different activity sectors, the VAT amount collectible for each investment tied to the production of tax-exempted goods and services was computed as follows:

$$IVAIP E_i = IPE_i \times t_5$$

where:

$IVAIP E_i$	VAT potential collection arising from the investment of sector i tied to the production of tax-exempted goods and services
t_5	VAT base rate

In the case of the investment intended for the production of export goods and services, the calculation was as follows:

$$IVAIP EX_i = IPEX_i \times t_5$$

where:

$IVAIP EX_i$	potential VAT collection arising from the investment of sector i associated with the production of export goods and services
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Therefore, the total potential non-deductible VAT to be collected each year from the investment targeted at producing tax-exempted (IVAIP E) and export (IVAIP EX) goods and services was obtained as follows:

$$IVAIP E = \sum_i IVAIP E_i$$

$$IVAIP EX = \sum_i IVAIP EX_i$$

Hence, the total non-deductible VAT tied to the private investment (IVAIP) was determined as:

$$IVAIP = IVAIP E + IVAIP EX$$

Annex 2: Obtaining the taxable amount of IRIC/IRAE through the EEB

According to the effective legal regulations, the taxable amount of the tax should be determined to pay the income tax, which results from the maximum between the taxable rate, if positive, and zero, in the case of loss.

$$MI = \text{Maximum} \{ RF, 0 \}$$

Below is the taxable income broken down by its main components, which are the Accounting Net Result (RNC, in Spanish), plus the result of the tax adjustments themselves (AF, which may be positive or negative), less the non-admitted expenses (GNA), plus increased deductions.

$$RF = RNC (+/-) AF - GNA + DI (1)$$

The RNC originates in the operating income (IO, in Spanish) from sales and other income, minus direct costs (CD, in Spanish), which are the costs associated with the production of goods and services, minus administration and sales expenses (GAV, in Spanish), plus the result of other revenues and expenses (OIE, in Spanish, which may be positive or negative), plus the financial results of the year (RFI, in Spanish, which may also be positive or negative), which relate to earned interest and bank expenses, among others.

$$RNC = IO - CD - GAV (+/-) OIE (+/-) RFI$$

The main tax adjustments are: the adjustment for tax inflation (AJI, in Spanish), to reflect losses or gains of the company during the economic year and which are attributable to the holding of assets/liabilities during inflationary periods, the loss generated in previous years (PEA, in Spanish) and investment-based exemptions (EI, in Spanish), whose term and property payroll have been extended under the New Tax System.

$$AF = AJI + PEA + EI + \text{Others}$$

The **GNA** is the result of applying the “padlock rule”, which states that 100% may be deducted if the person who sells the service or good also pays the IRAE tax; otherwise, in a certain proportion depending on whether such person is an IRPF taxpayer or as per letter E (small-sized company).

The **DI** refers to the expenses incurred in staff training and quality improvement and expenses for scientific innovations.

As approximation to the taxable amount, the operating surplus (EEB) is used, which is the result of the difference or balance in the income-generating account of the National Account System.

$$EEB = VAB - RA - (T-S) (2)$$

And it corresponds to the Gross Added Value (VAB, in Spanish), which is the gross production value once the intermediate consumption is deducted, minus remunerations (RA), and after subtracting the taxes applied on production minus subsidies (T-S).

By making (1) and (2) comparable, the result of the taxable amount is as follows:

$$MI = EE - RE (-/+) AF - GNA + DI$$

The RE being the tax-exempted income, which is included in the operating surplus but is not covered by the tax, so is therefore deducted.



Instruments and Techniques for the Measurement of Evasion

1. Theoretical framework.
 - 1.1. Conceptualization.
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Carlos Marx Carrasco
(Ecuador)

1. THEORETICAL FRAMEWORK

1.1. Conceptualization

Tax evasion is any fraudulent action to prevent the total or partial payment of a tax (Fiscal Studies Institute). All elimination or reduction of a tax amount produced within a country, by those who are legally obliged to pay (Villegas et. al., 2005).

This practice is conscious behavior done in a covert and deliberate manner. However, it may be the case that evasion is unintentional and open (for example: travelling salespersons), derived from a precarious socio-economic system which excludes from the formal system a segment of the population. From this point of view, informality is part of evasion.¹

The Royal Commission on Taxation of the United Kingdom, defined in 1955, evasion as any activity from which a person does not pay the tax required by existing legislation (Cosulich 1993). As Seville (2005) states, the tax gap or evasion rate is the distance between the collection which would be received by the State, if all taxpayers comply strictly with the standard (potential collection) and the collection that effectively entered into the Treasury.

The causes of evasion are not unique, for Lamagrande cited by Aquinas (2008): *“the examination of the phenomenon of tax evasion, allows us to infer its degree of complexity and dynamic character.” Its reduction depends on the removal of the factors involved in such dynamic, and a series of measures appropriate to a given, economic and social context should be carried out in order to achieve this. “Without detriment to circumstances beyond the economic tax field can improve or affect the level of tax compliance.”*

1.2. Why measure evasion?

The criminalization of this act is justified as evasion infringes upon the State's tax basis and undermines the social economy of the market (Ugalde and García, 2007). The importance of the tax burden and its influence on production costs, marketing and service delivery, makes the evading taxpayer enjoy advantages when compared to the rest of the taxpayers. In addition to eroding the government's revenue (Tacchi, 1993), a tax system with high levels of evasion attempts against the real impact of the system, by altering the principles of equity and social cohesion which pursues the Welfare State (Cosulich, 1993 and Cardona et al., 2007)

Evasion is a stumbling block for development, balanced growth, and in general for tax system justice. Its measurement is justified for two reasons: (i) allows you to design an economic system to ensure a minimum level of well-being for its citizens, compliance with the principle of sufficiency and avoiding macro fiscal imbalances for the State, and (ii) is an essential input for the management of the tax administrations.

1.2.1. Economic Importance of Measuring Evasion.

The final purpose of a tax system is to provide resources to finance public expenditure (Jorrat, 1996). In this solidarity process between the State and society, the system is legitimized provided that it guarantees: (i) a minimum level of well-being through horizontal and vertical equity and (ii) the tax regime should

¹ As Portes and Haller (2004) state: *“Consensus seems to be increasing among the researchers of the developed world that the scope of application of the term informal sector covers “the actions of economic agents that do not adhere to the institutional standards established or those to which their protection is denied.” (Feige 1990, page 990). Or, includes “all the income-generating activities not covered by the State in social environments where similar activities are regulated.” For example, unpaid domestic work is an informal activity but it does not affect taxes. Thus, remuneration received by workers of the informal sector may not involve tax evasion if pensions are within the exempted tranche” (A definition of informality).*

support balanced and sustained economic growth². The importance given by a Government to one or another will depend on the ideology it pursues, but there is no doubt that these two objectives must be present in greater or lesser extent in a tax system

Erosion of tax revenues from evasion brings difficulties to the State to run an efficient social policy. It is estimated that every year about 160 billion dollars are lost due to tax evasion throughout the planet, by invoices counterfeiting and transfer pricing alteration between related parties. On the other hand, if we consider that the budget allocated by developed countries to help poor countries is 103 billion dollars, if evasion is controlled, it could cover more than 1.5 times this budget (Murphy et. al, 2007).

Tax evasion, limits the development of the economies, especially those that do not have a strong tax system. According to Martens (2007), this practice will be responsible for the death of 5.6 million children for the 2000-2015 period, this means 1,000 children per day.

In 2000, the Millennium Development Goals were formed as an effort to eradicate poverty and promote development. However, until 2015 - the end date for the goals – the developing world will have lost 2.5 trillion dollars from evasive practices. In this respect, the World Bank estimates that 0.9 trillion dollars would be needed to meet these objectives in the project implementation period. Evasion would cover 2.7 times that figure (Martens 2007).

In addition to the effects on poverty, the asymmetries in the distribution of income present a positive correlation with the weakness of tax systems. Lax tax systems have preferred regressive indirect taxes for their ease of collection. In poor countries only 16% of tax revenue comes from income tax, while 32% is generated by excise taxes. In rich countries these ratios are 28% and 25% respectively (Martens 2007). The dismantling of direct taxation in developing countries has been accompanied by rising inequality, where in the last 20 years the Gini coefficient has increased in 53 of 73 developing countries (Martens 2007).

Evasion affects welfare because it breaks both the horizontal and vertical equity³. In the case of vertical equity, the effective tax rate⁴ of two individuals with different income may be the same because one of them uses mechanisms to reduce its payment. In the manner way two individuals who have equal income may be subject to a different tax rate if one evades its taxes, violating the horizontal equity of the tax system.

Evasion damages growth. Companies that evade their tax obligations have advantages over those that do comply, as mentioned by Stiglitz these distortions produce market failures since the true costs of production or income are not collected, this limits the growth of the affected economies. Even the imbalance that exists between productive sectors (monopolies) in developing countries causes evasion amounts to be centered in large corporations. This creates incentives to capture political power spaces achieving the establishment of foreign policy, tax or industrial incentives, legalizing evasion and causing the tax burden to fall on traditional economic groups (Prats y Macias-Aymar , 2008).

Gold mining companies in some African countries have total VAT exemption for imports and local procurement of goods and services. Finally, according to UNDP in Southeast Asia agriculture accounts for more than 30% of GDP and contributes to less than 6% of government revenues.

The evasion practices of large corporations with institutionally weak Governments generate growth based on the exploitation of natural resources which is concentrated on export sectors of low value added

² *Balanced, because growth may generate greater asymmetries in the distribution of wealth, therefore a mechanism to prevent this must be put in place; and sustainable, because the purpose is to minimize the fluctuations of economic cycles in time.*

³ *Vertical equity refers to the equal treatment of equals, while horizontal equity is the unequal treatment of unequal.*

⁴ *The effective tax rate is defined as the ratio between the taxes assessed on the individual's income. This indicator shows the society's relative degree of tax compliance.*

products. An example is the Democratic Republic of Congo, who in 2006 received the negligible value of US\$86,000 for mining rights. Tanzania is another example of this problem, because it has the largest gold reserves of the continent after South Africa, and only receives 3% of the value of total exports of this mineral.

Ultimately, problems generated by evasion on the economic growth and social welfare have economic-political impacts. High levels of evasion weaken society's confidence in the State, and produces lack of legitimacy in its actions. This lack of legitimacy along with high social inequality hinders the emergence of a credible and sustainable fiscal compact (Prats and Macias-Aymar, 2008).

1.2.2. The Importance of Measuring Evasion for the Tax Administration.

According to Jorrat (2003) it is important for the Tax Administration (TA) to have information on the amount of tax evasion in an economy for several reasons. First, it allows the tax administration to orient control plans. Tax control planning should be based on information on quantifiable economic activities and riskier geographic zones and the most used evasive methods. To do this it is essential to quantify this phenomenon not only at the aggregate level, but at sector and territorial levels as well.

Second, it allows you to monitor the results of examination plans and make changes when necessary (Jorrat, 2003). Not having a priori evasion information limits control plans and may cause errors when defining examinations. In the same manner, without evasion figures prior to the tax control prevent assessing how effective these controls were. This delegitimizes the action of the State and causes the TA to enter into a vicious circle where evasion schemes are based on subjective aspects that increase the probability of failure.

Third, tax evasion is an indicator of the efficiency of the Administration (Jorrat, 2003 and Trujillo, 1998). [All] tax systems face difficulties when differentiating between the collection product trend growth of the economy and the proceeds generated by the management of the tax benefit. This issue is resolved, in part, by having periodic measurements of evasion levels which can distinguish the level of efficiency of institutional management, of the inertia of the economy.

Fourth, the Government should consider evasion when deciding the TA's collection goals and when analyzing any amendments to the tax legislation (Jorrat, 2003 and Trujillo, 1998). If in the course of time, evasion figures in a country does not decline or tax pressure rates do not increase, the tax authority should consider two possible causes: (i) or control plans are not producing the results expected and would have to change the strategy, or (ii) the existing legislation is being an obstacle to improve compliance, therefore a legislative change should be considered. These conclusions can only be reached when a regular quantification of evasion rates are maintained.

Fifth, evasion rates, along with Tax Expenditure quantifications must be inputs for the Parliament and the Executive power at the time of establishing the general State budget. It must also be an important input for bills seeking to assign benefits and tax incentives to the different economic sectors or geographical areas. State policy consistent with national objectives could not assign economic or tax incentives to economic activities that maintain high levels of evasion.

Sixth, to know the evasion breakdown helps to identify the economic sectors that would require a higher degree of simplification of the tax system or in its absence an increased investment in the tax culture to insert it into the formal system. This can be the case of simplified regimes, where proper quantification of evasion by population segments help design a simplified regime that will formalize persons requiring a system of this kind, and not on the other hand be regimes to help evaders. Quantifying evasion can help simplifying the system and reduce informality.

Finally, as noted by Trujillo (1998) to measure evasion especially dimensions the problem. To not know what is the magnitude of the problem prevents finding optimal solutions. Knowledge of the extent of evasion can allocate additional resources to improve institutionalism and/or the management of the Tax Administration.

2. METHODOLOGICAL FRAMEWORK

2.1. Methods to measure evasion in international literature

Estimates of evasion gaps are of particular importance in the management of the Tax Administration, because it enables the design of control strategies according to the characteristics of taxpayers and the aspects that provided for in the legal provisions.

Tax literature has stated different methodologies for measuring evasion. Some of them are focused on measuring total evasion (formal and informal sector), others the part corresponding to the GDP of the National Accounts System and omitted in tax returns and others to increase the informal economy or underground economy⁵. The main difficulty of the research in this field is that, by definition, evasion is not observable behavior outside of law. This implies, in the empirical framework, that a measurement as from existing databases in the tax administration cannot be obtained directly⁶.

The methods most used in the TA are indirect methods, which give a rough picture of evasion, do not attain to supply the necessary aspects for the design of control programs. In practice, three indirect ways to estimate evasion can be distinguished (Fenochietto 1999):

Tax Administration Reports. Consists of measuring the effect of tax default on the generation of income for the tax administration.

Macroeconomic aggregates. Is the use of the statistics of the National Accounts System, the labor market, the underground economy and tax default to approximate tax evasion

Microeconomic techniques. The use of surveys on a sample of taxpayers.

Hereinafter, the most used methods according to each category are described herein.

2.1.1. Macroeconomic Aggregates

The Monetary Method.

The monetary method estimates the size of the underground economy under the assumption that the relationship between the demand for money and national production does not remain constant. Technological innovations generate a decline in the preference for cash. If noted otherwise, the excess cash must be related to the presence of an underground economy under the assumption that money is being used more intensively than the formal economy. This method has limitations, since the demand for money is not a directly observable economic aggregate and the underground economy performs part of its activities in the formal economy.

The Physical Input Method.

The physical input method assumes a stable relationship between a physical input widely used in the economy and national production. Based on this relationship, the size of economic activity is estimated,

⁵ *Informal or illegal, underground economy can be defined as the network of transaction that occurs without complying with the tax regulations transgressing the law and evading taxes. This type of trade is reflected on the hidden sales made by the business, retail and wholesale. As such, this fraud involves in some cases the evasion of all taxes established.*

⁶ *However, the relative evasion method is an indirect process that makes exclusive use of the tax administration databases to estimate the evasion in respect of the best compliance practices in the universe of taxpayers.*

which is then compared to the production recorded in the National Accounts System. The difference between both figures is considered a non-reported economic activity and is associated with the evaded amount of tax revenue.

The Difference Method.

The difference method compares the income recorded in the National Accounts System with the income reported on tax returns. The difference of two numbers is the evaded income gap. In order for this method to make sense, national income statistics must come from sources other than the Tax Administration.

The Legal Tax Potential Method.

The premise of the legal tax potential method is that the National Accounts System figures are correct and are a good basis for the calculation of income tax and VAT. The evaded tax is defined as the difference between the legal potential tax and the tax in effect collected; this is, the difference between tax revenue that would have been obtained if all legal tax obligations had been paid, and taxes actually collected

The theoretical taxable base for the legal tax potential is estimated according to the tax:

- Value-added tax: final taxed consumption of households of the National Accounts System, plus the taxed intermediate consumption of business sector that produces exempt goods.
- Income tax: the excess gross exploitation, adjusted by monetary correction, less the surplus of exempt and excluded activities, the surplus of companies subject to presumptive income, prior periods losses that may lower the current taxable income, among other deductions, discounts and exemptions.

This method depends on the reliability of the statistics used, the informal value-added registry in the National Accounts System and the possible underestimation of the macroeconomic aggregates

The Constant Tax Coefficient Method.

In this method, the fiscal pressure of a year in which tax evasion was minimal is chosen and is used to estimate the potential tax for the year in study. The difference between the estimated tax and the actual tax is the evaded tax

2.1.2. Microeconomic Techniques

The Labor Market Method.

The labor-market method compares the labor participation rates, according to official statistics, with the same rates obtained from surveys done to companies and workers. As from the differences found and based on average workmanship productivity, non-reported labor income, and thus, tax revenues ceased to be received for this concept.

The Survey Method.

The survey method consists of obtaining information on taxpayers' income through a survey, which is a source different from income tax statements. Income determined by the survey is compared with the income recorded in income statements, and tax default is estimated based on this. The weakness of this method is that it is subject to sampling bias and the problem of the reliability of data.

The Fixed Point Sample Method

In the fixed point method an inspector visits a company, and stays during the working day to observe

the development of the activity. From there, the theoretical sales levels are measured, considering that when the taxpayer is subject to the control of its transactions the true sales level is reflected. However, the presence of the officer Inspector at the place being inspected may interfere with the taxpayer's and the buyers' behaviors. In this case, the figure measured under control is not comparable with the one recorded in other periods.

The Special Verification of Accounts Method.

The special verification of accounts method performs "line by line" audits, on a stratified sample of taxpayers, to determine the amount of taxes that are not paid for not abiding by the laws. The advantage of this method is that it is less expensive and complex than other survey methods and allows reliable estimates of different tax evasion by different segmentation variables (economic activity, geographic location, etc.). On the other hand, the limitation is in considering samples taken from the universe of filers, leaving out the informal economy.

The Relative Evasion Method.

The relative evasion method operates on a new concept of evasion, regarding it not as the decline in collection but as a decline of equity in compliance with the tax. In this sense, the method focuses on estimating horizontal inequality in tax evasion, i.e. quantify in what measure tax obligations are not complied among those that do comply. The procedure is to determine the level that each taxpayer should pay according to their activity and some variables as invested and sales level. The estimated tax for each taxpayer is compared to the level of average taxation in that all comply, to then estimate the relative evasion coefficient on the standard deviation of the compliance percentages.

2.1.3. Tax Administration Reports

The Selective Sample Method.

Selective sampling method compares the information presented in the returns by a selected group of taxpayers, through examination actions performed by the Tax Administration. The limitation of this method is in the fact that it must be complemented by other statistical tools such as surveys; because its estimate is not random it is highly skewed.

The Special Amnesties Method.

The special amnesties method quantifies tax evasion by using information from income tax returns under the protection of temporary amnesties. This method works on the assumption that taxpayers are induced to declare their actual income in exchange for the suspension of fines or other sanctions they may be subject to. The limitation of this method is that you can skew evasion downwards in the case of frequent amnesties, because in spite of favorable conditions, some taxpayers may continue preferring not to submit to the same to not report their real income and therefore have to pay a higher tax.

Graph 1. Summary of Tax Evasion Calculation Methods.

Method	Size - Informal Sector	CIT Evasion	National Accounts System (SCN) Production / Money Demand	Observability
Monetary Method	Size - Informal Sector	CIT Evasion	National Accounts System (SCN) Production / Money Demand	The demand for money is not directly observable. Furthermore, the underground economy carries out part of its activities in the formal economy.
Physical Input Method	Size - Informal Sector	CIT Evasion	SCN Production / Fully Used Physical Input	
The difference Method	Total	CIT Evasion	SCN Income / Income reported to the TA	National Income Statistics must come from different sources outside the TA
The Legal Potential Tax Method	Formal Sector	CIT-VAT Evasion	VAB- Production - SCN Consumption / TA Returns	Reliability and under calculation of the statistics used. The informal value added is not registered in the SCN
The Constant Tax Coefficient Method	Total	CIT-VAT Evasion	VAB SCN / TA Collection	The year taken to predict must have minimum evasion
The Labor Market Method	Size - Informal Sector	CIT Evasion	Official job-underemployment rates / surveys to workers and firms.	
The Survey Method	Total	VAT Evasion	Income survey / TA Returns	Sample is skewed and data reliability problems
The Fixed Point Sample Method	Formal Sector	CIT-VAT Evasion	Sample Examination Data / TA Returns	The presence of the inspector may interfere with the taxpayer's and the buyers' behavior, rendering incomparable data.
The Special Verification of Accounts Method	Formal Sector	CIT-VAT Evasion	Sample Examination Data / TA Returns	Samples only come from the universe of filers, leaving out the informal economy.
The Relative Evasion Method	CIT-VAT	Formal Sector Relative Evasion	TA Returns	This method only measures the degree of horizontal inequality in tax compliance
The Selective Sample Method	CIT-VAT	Formal Sector Relative Evasion	Selective examination data / TA Returns	Results must be complemented by other tools such as surveys; because its estimate is not random it is highly skewed
The Special Amnesties Method	CIT-VAT	Formal Sector Relative Evasion	Temporary Amnesties TA Returns	The evasion gap is skewed downwards in the case of frequent amnesties, because of the taxpayers' resistance to not report their real income.

Sources: Various sources.

Prepared by: Tax Studies Department

2.2. Research carried out on evasion in the internal revenue service

In Ecuador, investigations performed on the subject of evasion are fundamental tools for designing strategies to control and tax policy. These investigations are framed in macro and micro econometric techniques for estimating tax gap by sector and geographical location. In addition, there are studies that model the behavior of taxpayers as evasion agents in an environment of general balance.

In this regard, the work has been substantial. Hereinafter the studies developed to date.

2.2.1. VAT and Corporate Income Tax Collection Gap Estimate by Industry

At the end of the year 2007, the Internal Revenue Service developed an estimate of evasion by economic activity of the corporate income tax and the value added tax for the year 2004, taking into account the industries' classification of the Central Bank of Ecuador⁷. The methodology used is based on the process to assess the theoretical potential tax, as from consumption and the Exploitation Gross Surplus – EBE, in Spanish - (adjusted for informality) recorded in the Supply and Utilization Tables of the National Accounts System. This result is compared with the effective collection recorded in the statistics of the corporate income tax and the value added tax of Internal Revenue Service (Andean et., 2008) to estimate the evasion gap of each tax.

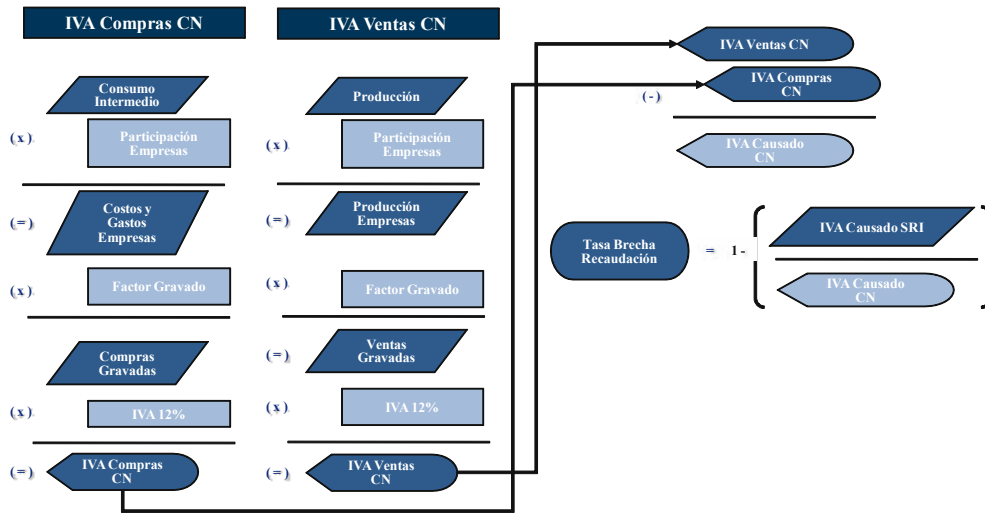
Hereinafter are the main methodological guidelines:

Value Added Tax (Graph 2)

- Standardize Supply and Utilization Tables.
- Identify taxable sales adjusted by informality (households and government consumption, investment in and stock variations) and apply the taxed factor to determine the Sales VAT
- Identify taxable purchases adjusted by informality (intermediate consumption) and apply the encumbered factor to determine the purchase VAT
- Calculate potential VAT (Sales VAT – Purchases VAT) through taxed factors in sales and purchases.

⁷ Validation of economic activities and their standardization according to the Central Bank of Ecuador industry codes was done only for special taxpayers, since they concentrate 75% of the collection. CIU3 economic activities that were the subject of thorough review were: crude oil extraction, natural gas and related services, the development of byproducts from oil refining, housing rentals, public administration and defense; compulsory social security affiliation schemes. It must be emphasized that the omission of this review can lead to erroneous collection gap rates.

Graph 2. Flowchart to estimate VAT Evasion Gap.

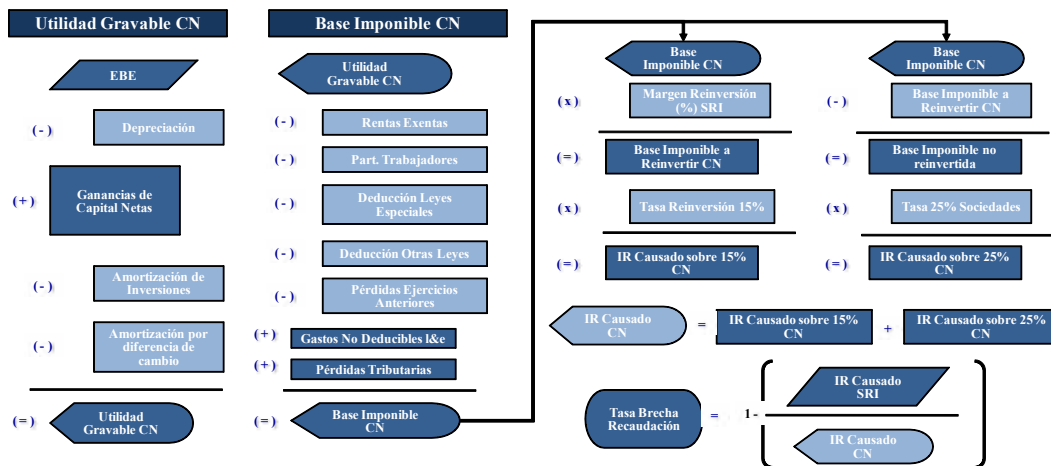


Source: Taxation Magazine No. 1
Prepared by: Tax Studies Department

Income Tax Assessed (Graph 3)

- Standardize Supply and Utilization Tables.
- Adjust the industries EBE of the national accounts system, excluding financial intermediation, financial expenses, and depreciation and amortization services; and including financial income, to obtain the profit or loss balance of the fiscal year.
- Subtract the balance of tax reconciliation (exempt income, workers' participation, deductions and depreciation, less non-deductible expenses and losses in past years) recorded by taxpayers to obtain the tax base.
- Estimate the theoretical potential tax by applying the 15% and 25% rate, depending on whether if a profit reinvestment or not⁸.

Graph 3. Flowchart to estimate CIT Evasion Gap.

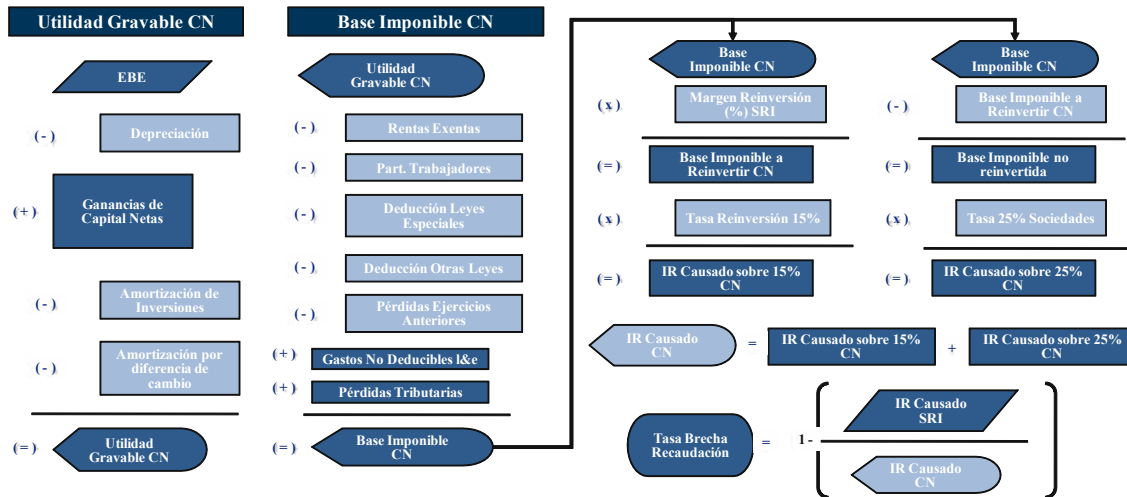


Source: Taxation Magazine No. 1
Prepared by: Tax Studies Department

⁸ The reinvestment percentage passed from 15% to 10% during the December 2007 reform.

Regarding the results, the VAT global collection gap was estimated at 30,6%, where (80%) is heavy industries, (53%) mid-size industries, (52%) oil and food and (47%) mail and telecommunications, the activities that are the highest evaders in Ecuador's economy (Graph 4).

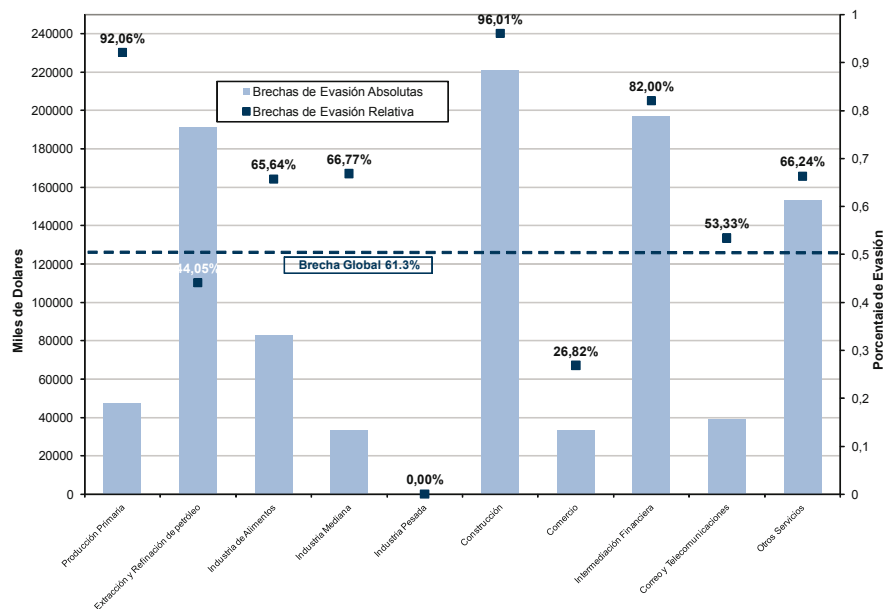
Graph 4. Corporate VAT Evasion Gap. Year 2004.



Source: Taxation Magazine No. 1

On the other hand, the overall income tax gap was estimated at 61.3%. Industries that had a gap above this level were primary production companies (92%), food (65%), mid-size industry (66%), construction (96%), financial intermediation (82%), and other services (66%) (Graph 5).

Graph 5. Corporation CIT Tax Gap. Year 2004.



Source: Taxation Magazine No. 1

2.2.2. General Applied Tax Balance Model

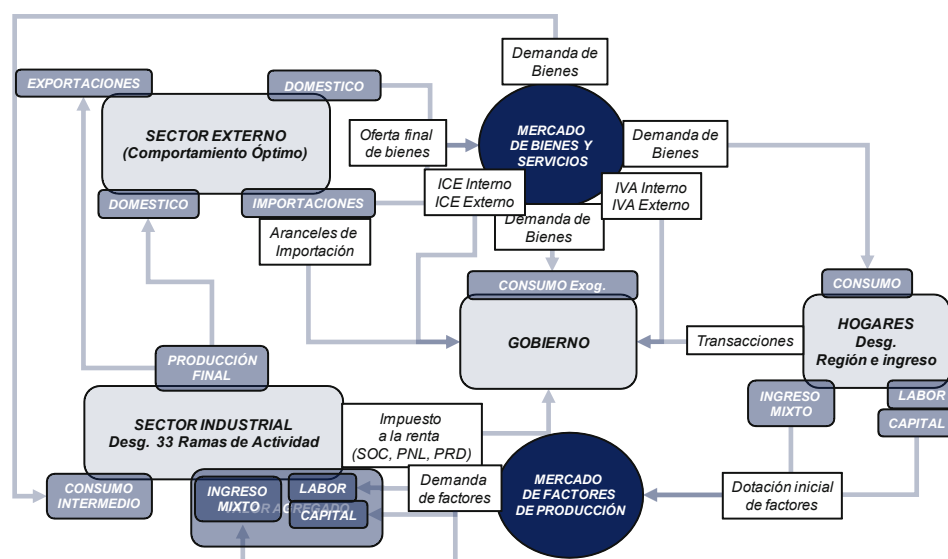
Today's complex environment includes existing interrelationships between social and economic variables, which call for improvements in macroeconomic modeling, in order to capture the economic reality of a country in a more positive way and specify results in the evaluation of economic policy. One of the topics of greatest interest here has been tax evasion because its correct set-up in the economic system helps to specify the tax incidence analysis and identify the main factors in tax revenues.

The General Applied Tax Balancing Model (MEGAT, in Spanish) was born as a counterfactual analysis tool of policies in the Ecuadorian economic system, with incorporates the tax evasion behavior into the VAT added value tax and the Assessed Income Tax payment. Therefore, some specific approaches are adopted as the model of Adgnmano and Salmano (1973) in the payment of direct taxes and the perspective of Marrelli (1979) in the payment of indirect taxes.

MEGAT as other general equilibrium models is formulated from competitive markets in a small and open economic system with increasing or decreasing technologies in the production and external marketing of goods and services, responding in principle to the concept of Walrasian Equilibrium for all agents and markets that form the same.

This economic system initially comprises 31 production sectors that supply and demand between 31 goods and services present on the domestic market, in addition to the exports and imports thereof done as from 3 different regions in the world (USA, Andean Community and the rest of the world). Furthermore, there are 2 institutional actors in the economy; one consolidated by 6 types of households (classified in urban skilled and unskilled, and rural non-agricultural, small and large producers) which offer 3 types of factors of production (remunerations mixed income and gross surplus exploitation) to the productive sector for revenue and perform their consumption activities and another formed by the Government whose main activities are tax collection (internal and external ICE, internal and external VAT, income tax, tariffs) and its later distribution into the economic system (Graph 6).

Graph 6. National Economic System, MEGAT Basic Dimensions



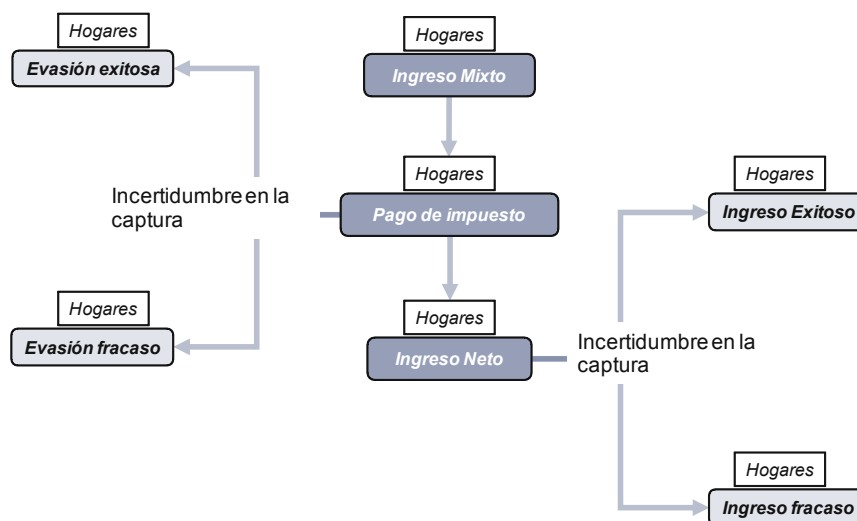
Source: Applied General Tax Balance Model
Prepared by: Tax Studies Department

Tax Evasion in the Payment of CIT corresponding to individuals.

In principle, the presence of an evasion agent in the production sector that detaches the behavior in the payment of the CIT by individuals, similar to how it is done in the Adgnmano and Salmano model; introducing perception close to the control done by the tax administration within the detection probability handled by the agent. Additionally, it is assumed that this agent in spite of also declaring VAT, does not evades it due to withholding and control mechanisms scattered in the economic system.

As a result, this taxpayer decides to evade or not depending on the expected usefulness of its income, assuming that there is an endogenous and changing possibility (as perceived through its behavior) of being detected and fined later by the Tax Administration. If the taxpayer decides to evade but is not detected, it shall receive additional income for concealing part of the taxable amount which should have been paid a given tax rate; otherwise, if the taxpayer is detected evading income, it will have to pay a fine on the taxable base that it concealed, which generally is greater than the current tax rate, with the purpose of discouraging evasion (Graph 7).

Graph 7. Individuals CIT Evasion Flowchart.



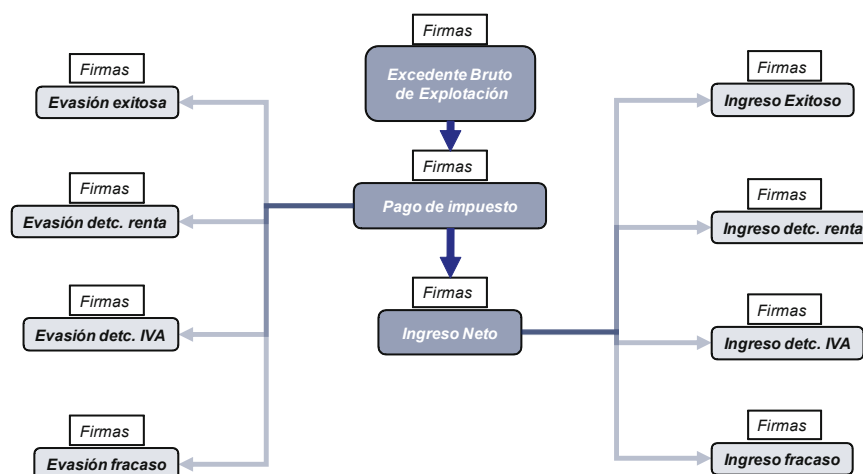
Source: Applied General Tax Balance Model
 Prepared by: Tax Studies Department

Tax evasion in the payment of Corporate VAT and CIT.

In the previous structure, another module is integrated to disassociate behavior in the payment and evasion of the CIT on the profits generated by the production sector. Furthermore, it is assumed that these taxpayers are the only ones in the economic system that have the option of evading or not the payment of the VAT.

Corporations have the option of concealing part of the taxable base in the payment of the CIT, VAT, or both, to increase their income considering the possibility of being discovered, audited and sanctioned. Other hand, the likelihood of capture known and perceived by the taxpayer represents the control done by the Tax Administration, given the type of evasion that it carried out (Graph 8).

Graph 8. Coporate VAT-CIT Evasion Flowchart



Source: Applied General Tax Balance Model
Prepared by: Tax Studies Department

MEGAT enables the evaluation of the impact of a tax policy in the economic system and the change in evasion gaps.

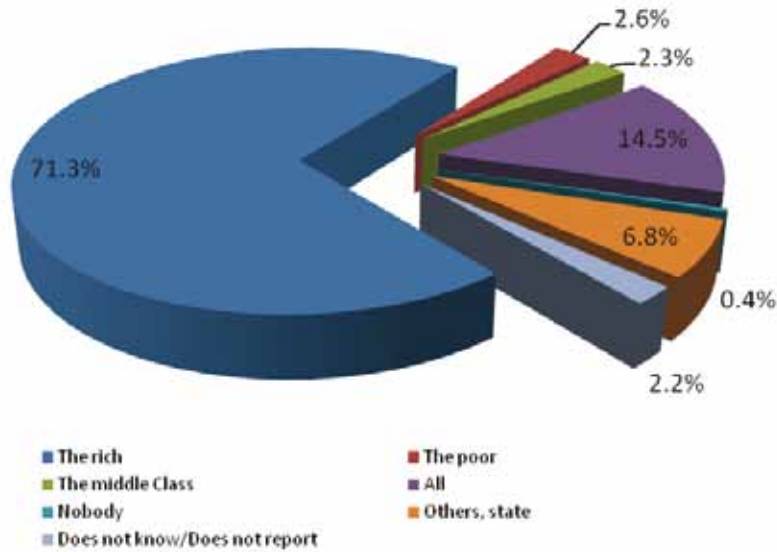
2.2.3. SRI User Satisfaction Survey. Perception of Evasion.

The Internal Revenue Service user satisfaction survey was a process developed in December of 2008. The objective of this survey was to determine the level of satisfaction and the degree of improvement that the institution has had in the different services offered to taxpayers and users, through questions such as: type of service used, rating of the services provided by employees, consultants, returns, and access to services through the Internet, etc. It also stated certain questions to measure the taxpayers' perceptions on evasion control and sanction topics, (2009 INEC).

This survey was done through direct interviews to people attended during December at the different agencies of SRI nation-wide, after concluding the process that brought them to this agency (Intercept Method). The database contains the opinions of 2,865 taxpayers, distributed proportionally according to the size of the 8 regional offices.

According to the taxpayers' opinion on evasion by economic strata (Graph 2), 71.3% of the total number of taxpayers, believe higher-income people are the main source of evasion. Furthermore, a 14.5% believes that all people in general evade taxes and 6.8% believes specific taxpayers, such as merchants and large companies are the greatest evaders. These statistics allow insight into the theoretical results of some evasion models, such as directly proportional relationship between income and the individuals' susceptibility to evade taxes.

**Graph 9. Who do you think are the ones that evade most taxes?
Perception Survey. Year 2008**



Source: 2008 Perception Survey
Prepared by: Tax Studies Department

Regarding the taxpayers' perception on the reasons that motivate evasion behavior (Graph 3), 18.4% and 11.5% of the population surveyed believes that the desire for greater profit and wealth, are respectively the main reasons that encourage tax evasion. Likewise, 10.9% believes evasion is caused by acts of corruption.

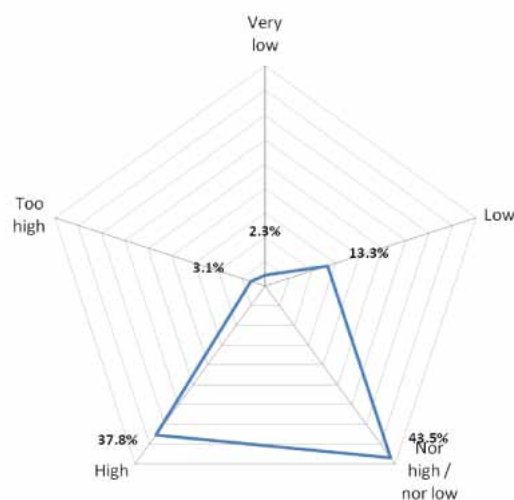
**Graph 10. Why do you think people evade taxes?
Perception Survey. Year 2008**



Source: 2008 Perception Survey
Prepared by: Tax Studies Department

Finally, the subjective probability of detecting non-compliance with tax obligations probability is also collected and analyzed. 43.5% of taxpayers state that this probability is either very high or very low; while 37% think that this possibility of being captured is moderately high. Furthermore, less than 15% of the population believes that this probability is low or very low.

Graph 11. The Probability that the SRI Detects Taxpayers in Default with their Obligations Perception Survey. Year 2008



Source: 2008 Perception Survey
Prepared by: Tax Studies Department

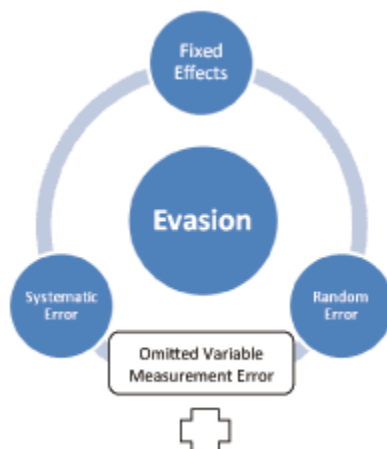
2.2.4. Fiscal Gaps according to Economic Activity and Region.

In 2009, the Internal Revenue Service showed its interest in the development of new methods to estimate evasion gaps, by applying different conceptual frameworks from traditional ones such as relative evasion. With this initiative the tax gap study on economic and regional activity arises, where in an econometric manner the collection gap in the statement and payment of Bodies Corporate (Corporations) Income Taxes is estimated, by the place of the generation and activity of the economic fact during the 2003-2007 terms, by using the financial statements approximately 40,000 taxpayers.

To do this, two panel models are proposed, based on a variant of the estimation technique for the total productivity of factors, which incorporates the approach of omitted variable and measurement error by stochastic frontier in the tax return. Both models aim to estimate the evasion gap and analyze its sensitivity, since the great uncertainty surrounding the measurement of the non-observable component makes this process necessary (Aguilar and Castro, 2009)

Both models consider the phenomenon of evasion as an unobservable component that does not change over time, due to the existence of norms and institutional structures that enable its permanence in time. This phenomenon is possibly infiltrated among legal mechanisms used to minimize the tax payment on a sector basis, however the determinants of these elusive practices occur in a totally different context. False random occurrence for errors or potential errors in the tax reports are added to this. Together, both factors constitute the measurement error in the econometric estimation.

Graph 12. Methodological Proposal



Source: *Fiscal Gaps according to Economic Activity and Region*.
Prepared by: Tax Studies Department

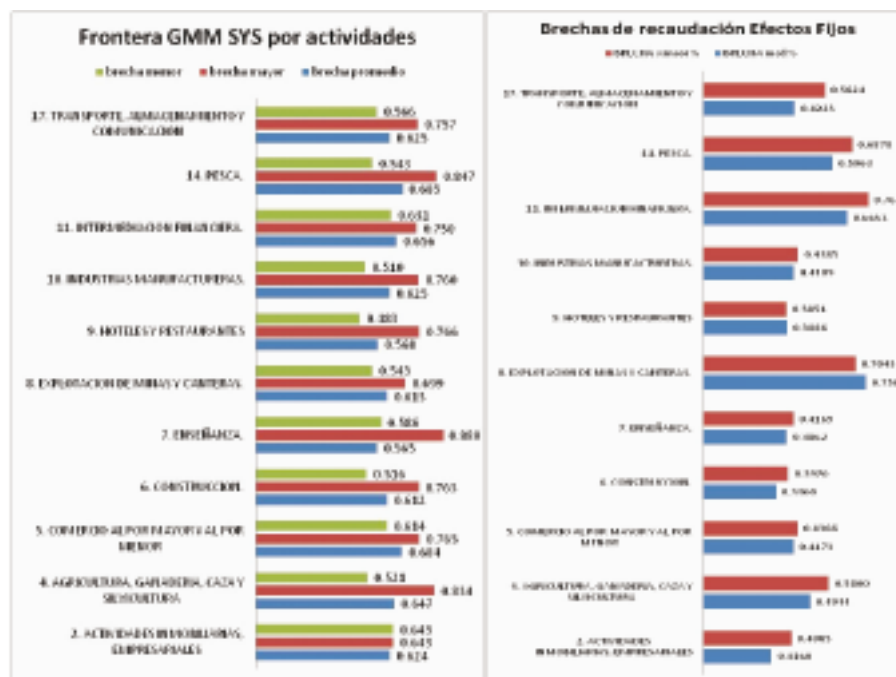
The first methodology uses a Fixed Effects Vector Decomposition (FEVD), which quantifies the bad tax and business practices gap through the time-invariant according to economic activity. In order to extract the tax gap, on this component a regression is done on the variables similar to the business efficiency, such as total and intangible assets, total labor costs, the company's age, percentage market share and total asset concentration. The residues obtained from this regression are used later to adjust the tax assessed on companies at a potential amount, which is later used to establish a potential maximum tax of the "best tax practice"⁹ pursuant to various statistical criteria¹⁰ (maximum level, Winsor 95%, minimum covariant distance). Facing this standard, the evasion gap is estimated by type of activity, comparing in relative terms the average real tax assessed.

The results of this model indicate that Mining and Quarries Exploitation, financial intermediation, fisheries and transport, storage and communication activities are the most important sectors with gaps ranging from 75% to 42% in deflated terms for 2003-2007 period. This value represents the average distance (in percentage terms) between the corporations of this activity and the companies that have the better tax compliance, given that a constant level of sales is maintained, expenses, labor, assets, leverage and other explanatory variables (Graph 12).

⁹ It is important to mention that this best tax practice considers that all the other aspects affecting the tax assessed are constant, that is: total assets, labor expenses, sales, intangible capital, among others. That is, it attains to make companies comparable. Therefore, a better practice does not mean to pay more taxes in absolute terms, but how much the payment of the company regarding its expected value defers, maintaining systematically constant its characteristics during the five years considered. In this regard, the maximum potential tax or the benchmark is real tax level that has been attained by at least one company in the study – although generally there are more -. More specifically, it is the tax that would be attained given the average characteristics of the sector and the best tax practice.

¹⁰ Statistical criteria used constitute the maximum level, the Windsor Measurement 95% and the Minimum Covariance Distance - MCD.

Graph 12. Fiscal Gaps



Source: Fiscal Gaps according to Economic Activity and Region.
 Prepared by: Tax Studies Department

The second model consists of a Generalized Moments Model System (GMM-SYS), which incorporates more complex elements of statistical theory (instruments in delays and differences) to the specification of the previous model to correct measurement errors, concurrency¹¹ in the estimation of tax determinants.

This tax expected from this model is divided for the one obtained by Minimum Ordinary Squares (MCO, in Spanish), taking the resulting coefficients as a proxy for poor tax practices.

The logic of this process is that if there is a systematic measurement error in the signatures log balances, the predicted value of the corrected model will provide a good approximation of the actual value, and therefore any difference on this (as compared to the estimate by MCO) will determine the unobserved fiscal gap.

On these coefficients, the procedure is the same as in the previous model to obtain the tax gap by type of activity, establishing the potential maximum tax of the “best tax practice” in each sector.

This alternative form of estimation does not change the results significantly at sector level, thus demonstrating the strength of the same, at least for the sectors with higher tax gap. In general, the results again displayed a fairly stable average gap for the four sectors with greater gap estimated in the FEVD model.

However, it is important to highlight that construction activities, are situated at a higher level of evasion 50% than that previously estimated of 33% (Graph 12).

11 Concurrency is an endogenous problem that occurs when one or more of the explanation variables is determined jointly with the dependent variable, through an equilibrium mechanism.

3. DISSEMINATION AND ACTIONS UNDERTAKEN TO FIGHT EVASION

3.1. Actions to fight evasion, contraband and informality

Once reviewed the quantitative tools to measure the evasion, it is important to analyze the use given to the quantification of evasion in the formulation of tax policy and improving the management of internal revenue service – SRI, in Spanish-, aimed at combating tax fraud.

The estimate of the evasion gap was done jointly between the Tax Studies Department and SRI's National Directorate of Tax Management. The estimation methodology was laid-out and discussed in different technical institutions, such as the Central Bank of Ecuador and private trade unions, such as chambers of commerce, industry and construction.

In September 2007, the Ecuadorian Tax Administration unveiled the gap evasion for Ecuador, the figure reached US\$ 2.4 billion; 61.3% in income tax collection and 31% in VAT, and these figures were published in various media outlets.

“The director of the SRI reported annual tax evasion reaches approximately US\$ 2.4 billion.” Tax evasion in different sectors is: primary production 96%, financial intermediation 82%, industry 66%, food 65.6%, mail and telecommunications 53%, extraction and oil refining 44% and trade 26.82%.” (Diario del norte, page 12, 2007)

Thus, the Tax Administration disseminated evasion data through the SRI institution Magazine “Taxation” in April 2007. “Taxation” magazine addresses various and vitally important issues for the country which enable public decision-making based on theoretically based arguments and on economic, social and actual facts.



Jointly with the release of “Taxation” magazine, the SRI disseminates General Applied Tax Balance Model (MEGAT), as a tool for the evaluation of economic policy that allows distinguishing taxpayers’ tax evasion of in the economic system.



In July 2008 the Inter-American Center of Tax Administrations (CIAT), together with the SRI organized the “International Taxation, Evasion and Decentralization Seminar” in Ecuador, which discussed the methodologies for the calculation of evasion and possible mechanisms for combating tax fraud.

3.2. Strategies

3.2.1. Tax Reform

One of the main objectives which motivated the tax reform “Tax Equity Act” was the reduction of tax evasion, increase the taxpayer base and strengthen tax control.

3.2.2. Creation of a Large Taxpayer Department

To lower tax evasion, the Tax Administration created the Large Taxpayers Control unit. For October 2008, the tax administration exceeded their tax goals among other things, for greater tax evasion control, especially Large Taxpayers.

3.2.3. Focused Tax Assessments

In October 2007 the Tax Administration announced that the construction sector had a 96% gap of evasion. From this estimate, SRI determined glosses for about \$ 111.1 million to this sector.

Furthermore, during the 2007 - 2009 periods the Special and Large Taxpayers of the transportation, telecommunications, oil, agro-industry and industry sectors were audited and this generated a total debt of US\$ 315 million.

3.2.4. Reduction of Informality through Simplified Tax Systems

In August 2008, the Internal Revenue Service presented the Ecuadorian Simplified Taxation Regime (RISE, in Spanish), which replaces the payment of the Value Added Tax (VAT) and the Income Tax (IT),

through monthly quotas provided for by law.

In this manner the Tax Administration seeks to facilitate payment by small and medium size businesses to fight evasion and economic informality.

3.2.5. Promote Tax Culture

The low tax culture is one of the factors causing tax evasion. Therefore, SRI defined strategies to change tax culture in the country and develop the concept of “tax citizenship”. This concept is understood as the commitment of individuals with society, to exercise the correct and ethical use of their rights and fiscal obligations based on the trust of fair and transparent public spending as well as the reciprocity of the participating public agencies

In this context, the Internal Revenue Service declared the 28 April “Tax Culture Day.”

3.2.6. Implement the Statement of Assets and Liabilities for Bodies Corporate

One of the mechanisms for combating the evasion and controlling individuals was the implementation of the statement of assets and liabilities to estimate the different incomes of the taxpayers. This information is confidential in the Tax Administration.

3.2.7. Promote Billing

In order to prevent tax traps and false invoices, the Tax Administration made changes to the invoices emission authorization process.

Thus, the “1-800 Factura” (1-800 invoice) program was created to address citizens complaints for the non-delivery of sales vouchers, mainly in the health, housing and real estate lease sectors

3.2.8. Generate Risk

With the purpose of generating risk in the productive sectors and reduce default caused by lack of information or a wrong advice, workshops were organized where the concerns and interests of economic sectors were addressed.

The following were among the topics presented: the omission of income, the economic fact, expenses without livelihoods, the treatment of remunerations, the depreciation of fixed assets, bad accounts provisions, amortization of deferred assets, refunds and “gross up”, under capitalization, commercial leasing, low inventory, fixed assets, casualties tax reconciliation, transfer pricing and estimated assessment.

Furthermore, the procedures to be followed by taxpayers in accordance with tax legislation and the tax control process of the Internal Revenue Service were explained.

In addition, the procedures to be followed in accordance with tax legislation and the process of the Inland Revenue Service tax control taxpayers were explained.

These workshops were done with the participation of different trade unions, such as: Industrial Chambers, Chambers of Commerce, Accountants Associations and the Office of the Comptroller General

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Use of the Results of Tax Gap Measurement for Structuring the Risk Map and Designing Control Plans

1. Introduction.
2. The underground value added.
3. Estimation of evasion of taxable amounts.
 - 3.1. Value added tax.
 - 3.2. Regional tax on productive activities (IRAP).
4. Conclusions
5. Bibliography

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1. INTRODUCTION

The Italian Tax Administration's (hereinafter, the Administration) activity is ruled by an agreement with the Ministry of Economy and Finance. Such agreement establishes the objectives to be met and the resources required to do so. The objectives are referred to the activities we shall pursue (number of controls and services rendered) as well as the collectible amounts following tax controls.

Knowing the objectives is relevant in fulfilling the Administration's mission, namely to maximize taxpayers' compliance with tax obligations.

In order to plan the strategy, face the potential risks and foresee the criticalities tied to the fulfillment of the mission, we must rely on appropriate methodologies to estimate potential collection, defined as the maximum collection enabled by current tax legislation¹. In other words, "potential collection is that which would be collected if no taxpayer would voluntarily breach the law and involuntary errors would amount to zero²".

The most critical factor explaining the gap between potential collection and effective collection is evasion, which stands as the main aggregate by which the Tax Administration's performance should be assessed³.

The objective of this paper is to present the sources and the calculation methods adopted by the Administration to estimate tax evasion as the missing portion of the tax potential, setting forth the uses of such indicator as a parameter to schedule the Administration's activities, making the most efficient use of the finite resources available.

Numerous publications are available on the possible methods to calculate evasion⁴. The Administration undertakes the top-down approach, chiefly based on comparing the tax data to national account aggregates.

The following measurements are especially considered: the underground value added, estimated by the Italian National Statistics' Institute (ISTAT, as per the Italian acronym) and two evasion estimations based on the VAT and the Regional Tax on Productive Activities (IRAP, as per the Italian acronym).

The calculation of the underground sets the general benchmark framework, VAT evasion follows an approach based on the exchange of goods and services (demand-side) and the IRAP is a proxy of the gap existing in the business profit-earning process (supply-side).

For the Administration to apply it clearly, we must first define the benchmark framework of the three indicators with respect to the taxable amount and the applicable potential collection:

- The comparisons based on the aggregates of National Account expenditures and the resources account (GDP, Final Consumption, etc.) comprise the transactions recorded on the businesses' profit and loss account and exclude the net worth status; therefore, the calculation of tax evasion from the collection amount is incomplete, since it fails to comprise evasion arising from changes in net worth;
- The national account system provides a reliable indication of the potential profit and not the subsequent tax; thus, we recommend comparing with the tax data on the taxable amount rather than on the tax potential;

¹ *Sevilla Segura (2006).*

² *Das-Gupta, Mookherjee (2000).*

³ *Viol (2006).*

⁴ *For a summary, refer to OECD (2004a, 2008).*

- From item 2, we may infer that all evasion types arising from an incorrect tax statement with a tax base that was filed correctly are excluded from the estimations (such as the application of a VAT rate different from the actual one).

Despite such limitations, the comparison with the national accounts' system data offers a wealth of information, since profit earning is the time of wealth creation of the country from which all the forms of taxation originate, directly or indirectly. On the other hand, tax evasion based on total or partial concealment of the tax base accounts for the most relevant form of tax evasion, since it is the most difficult one to identify.

For evasion indicators to have operating relevance, they are broken down to comprise type of tax (VAT, IRAP), economic sector, geographical area and taxpayer type.

The paper is structured as follows: the second item is aimed at informing on the methodology and the sources to calculate the underground value added employed by the ISTAT, the subsequent item discusses VAT and IRAP tax evasion and, finally, it presents a number of conclusions and references to future papers.

2. THE UNDERGROUND VALUE ADDED

Since 1993, the United Nations System of National Accounts (UNSNA) establishes that the national accounts estimations shall also include the informal economy. The informal economy includes different groups of activities; this paper shall focus on the underground economy, defined as: "legal productive activities that are not registered mainly due to a deficiency of the statistical data collection system or to economic reasons; that is, the will to avoid the tax and social contribution obligations in order to reduce production costs⁵". Therefore, the national statistics' institutes rely on methodologies that enable them to estimate and include the underground economy in national account aggregates⁶.

Within the underground economy, the ISTAT isolated the item that statistics fail to record owing to the economic underground⁷, which represents the legal productive activity which nevertheless escapes direct observation because of its connection to tax evasion⁸. The ISTAT applies the Labor input method (LIM) approach because the elements of the GDP are obtained by expanding into the universe the per capita data obtained from the studies undertaken in businesses through the employed labor input (measured in terms of Full Time Equivalent Unit, FTE).

To summarize, the estimation-development process is based on the following phases:

- a. Calculation of the total FTE considering the registered component (regular) and the non-registered one (irregular), the total regular and irregular FTE constitutes the national accounts' benchmark universe;
- b. Based on the studies performed in businesses, we may calculate the per capita values for output, intermediate costs and value added, with the possibility of correcting them as required, whether based on an invoice understatement or a cost overstatement;
- c. By multiplying the result obtained in b) by the FTE set forth in a), we obtain a preliminary supply estimation (GDP);
- d. The estimation of c) is part of an Input-Output system that compares with demand-side estimations (consumption, investment, etc.), since individuals are less reluctant to file the data on expenses than on income earned, the demand data exceed the supply and, based on such discrepancy, the new GDP correction is applied.

⁵ For a more in-depth analysis, refer to OECD (2002).

⁶ For a summary on the international methods employed, refer to UNECE (2008).

⁷ Baldassarini, Pisani (2000).

⁸ Always considering the caveats presented in the introduction.

Therefore, from a theoretical standpoint, the ISTAT estimations capture the concealment of the total added value produced (based on the estimation of irregular FTE) such as partial concealment arising from an invoice understatement or an exaggerated cost overstatement (items b and d).

The ISTAT regularly published the measurements of the economic underground⁹. Based on the latest data available, we may infer that in 2006, 16.9% of the GDP was produced by the underground sector (Figure 1). Likewise, 38% of the underground economy results from the employment of irregular labor and the remaining 62% is concealed with other methods. On the other hand, we may obtain a measure of the phenomenon by macro-sectors of activity (Figure 2), from which we infer that 80% of the underground comes from services, 17% from industry and the remaining 3% from agriculture. The small percentage figure of agriculture is based on the fact that this sector has very little impact on the GDP, and thus, although marked by high evasion rates, represents a marginal share of the underground economy.

Figure 1. Breakdown of the GDP based on the economic underground and its components

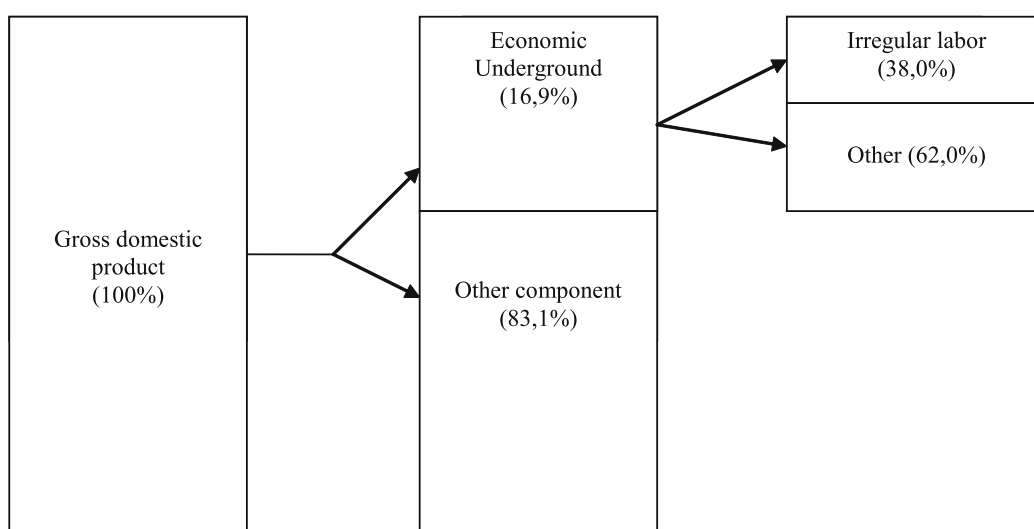
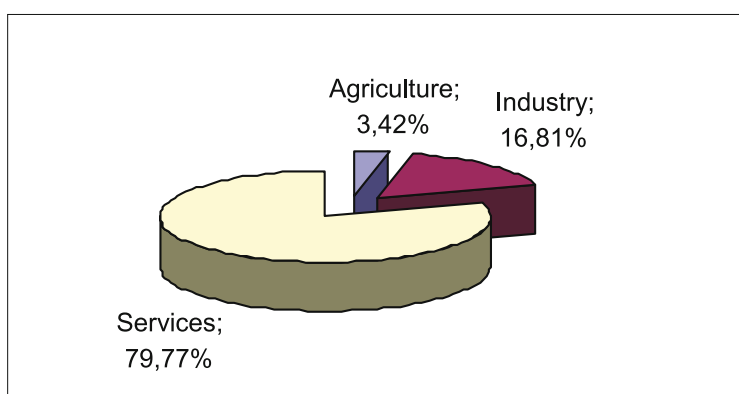


Figure 2. Breakdown of the economic underground by sector of economic activity



Source: ISTAT

⁹ For more updated estimations, refer to ISTAT (2008).

Therefore, the ISTAT estimations of the economic underground only provide the general benchmark framework of the potential taxable amount, but also suggest potential general guidelines on which to focus control activities (informal labor, etc.) and focus attention towards the macro-sectors posing highest risk.

Based on such features, the Administration employs the regional GDP calculated by the ISTAT as the indicator to assign the monetary recovery objectives that each regional office¹⁰ undertakes to attain in the budgetary allocation phase for the activities.

3. ESTIMATION OF EVASION OF TAXABLE AMOUNTS

The ISTAT information of the economic underground, although a relevant benchmark factor, fails to fully meet the Administration's need. Firstly, because the value added, to the extent it is an elementary unit of national wealth, represents an indirect indicator that excludes the regulatory specificities vis-à-vis the assessment of the tax bases.

On the other hand, we may actually observe that the evasion rate of the income produced may not be truly significant if it is tied to the tax bases stemming therefrom. Such differences may be due to: norms that regulate the assessment of the different tax bases, the degree of complexity of the obligations tied to the specific tax¹¹, the degree of difficulty in concealing certain types of taxes compared to others¹².

On such grounds, the Administration conducts its own tax evasion estimations, diversified by type of tax.

3.1 Value Added Tax

Tax compliance may be better analyzed when considered from the VAT approach. In fact, although it fully affects the end consumer, its transfer mechanism in the different stages of the productive and commercial chain makes it a "central" tax in the overall tax behavior. Many of the figures of tax evasion (concealment of the overall productive chain, understatement of income, overstatement of costs and/or accounting of inherent costs) are generated by a reduction of the VAT base.

The methodology adopted by the Administration accounts for the adjustment to the Italian reality of a method that is widely spread internationally, based on national account data¹³. The Italian approach is centered on the assessment of the potential VAT base, obtained by changing national accounts' flows to match them with the tax regulations.

Pursuant to the notions set forth in Reckon (2007), two tax evasion definitions are adopted: "not remitted" and "not collected" VAT base.

The first one (not remitted - without complicity) considers that there is no complicity between the selling party and the buying party and, therefore, tax evasion is materialized because the selling party fails to remit the VAT applicable.

The second one (not collected - with complicity) measures the tax base and the tax that the selling party did not invoice to the buying party by virtue of a mutual agreement; tax evasion is thus materialized by the selling party's failure to invoice.

The example in Chart 1 clarifies the difference between both behaviors. Chart 2 assumes three types of transactions between a selling party and the end consumer, who share the same VAT base of € 1,000.

¹⁰ *The agency is articulated across the territory in 21 regional offices.*

¹¹ *Androni et al (p. 852), Christie, Hozner (2006).*

¹² *Viol (2006).*

¹³ *Nam et al. (2001), HM Custom and Excise (2004), HM revenue and Custom (2006), Reckon (2008, 2009), in the case of Italy, refer to Marigliani, Pisani (2006).*

On the other hand, it entails a single tax rate amounting to 20% and the absence of costs deductible from the invoiced tax.

Transaction 1 is not affected by evasion, therefore, the selling party invoices VAT for a €200 amount, which is subsequently paid to the tax authority. On the national accounts, the amount registered in the consumption of families is € 1,200.

Transaction 2 assumes an agreement between the selling party and the buying party, according to which the former accepts an informal payment amounting to € 1,000, without the corresponding invoiced or remitted tax. On the national accounts, the amount registered on the consumption of families is € 1,000.

Transaction 3 does not feature an agreement between the selling party and the buying party; therefore, the former invoices the latter € 1,000 for the tax base + € 200 for VAT, but fails to deposit the money with the tax authority. On the national accounts, the amount registered on the consumption of families is € 1,200.

Table 1. Example of 3 types of transactions considered in VAT estimation (VAT rate=20%)

ID.	VAT base	VAT invoiced	VAT actually remitted	National accounts' figures	Economic behavior
1	1,000	200	200	1,200	No evasion
2	1,000	0	0	1,000	Evasion with complicity
3	1,000	200	0	1,200	Evasion without complicity
Total	3,000	400	200	3,400	

Chart 2 describes the way in which the transactions reported on Chart 1 are reflected on the evasion estimations. The base premise is the end consumption on the national accounts, amounting to € 3,400, which includes an actual VAT remittance amounting to € 200. This premise is related to the tax statements featuring a € 1,000 VAT base and a VAT remittance amount of € 200. Evasion, which is unknown in the aggregate, is € 2,000 for the base and € 400 for VAT.

If we assume that evasion occurs with complicity, we must subtract the actual VAT remittance (€200) from the National Account premise (€ 3,400), thus obtaining a potential base of € 3,200, € 1,000 of which have been filed and € 2,200 evaded. In this case, we overestimate the tax base evasion (€ 2,000).

Table 2. Impact of the different kinds of fraud on estimated tax evasion

N.A. figures: Final consumption = 3,400 of which: VAT actually remitted = 200
 VAT return: VAT base 1,000; VAT=200.

Effective evasion (not observable): VAT base = 2,000; VAT = 400.

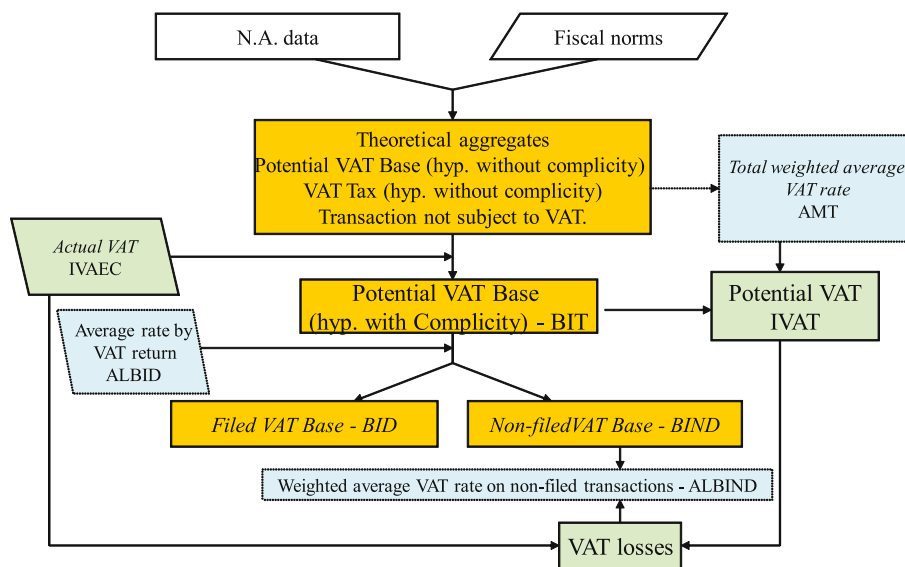
Aggregates	With complicity (Not collected)	Without complicity (Not remitted)
N.A.	3,400	3,400
VAT actual remitted	200	
Potential VAT base	3,200	3,400/1.2=2,833
Estimation of VAT Base Evasion	2,200 Overestimate	1,833 Underestimate

In the assumption that the overall fraud is perpetrated without complicity, the potential base is obtained by dividing the national accounts' data (€ 3,400) times 1 plus the theoretical tax rate (0.2). The result obtained is € 2,833, from which we subtract the tax base filed for € 1,000 to obtain an estimation of the evaded tax base lower than the effective one (€ 1,833 against € 2,000).

In this situation, it is impossible to differentiate between evasion with complicity and evasion without complicity; consequently, the Administration derives two estimations, considering both hypotheses, where evasion without complicity accounts for the bottom limit and evasion with complicity accounts for the top limit.

Figure 3 presents the flowchart of the potential tax base calculation method and subsequent evasion. It highlights the most relevant elements of the procedure: correction of national accounts' data based on the existing procedure, comparison with the data stemming from tax statements and the different steps to calculate evasion with complicity and without complicity.

Figure 3. Flow chart of the methodology used to estimate the potential VAT base and the Tax



The quality of estimations is strongly conditioned by the adjustments performed to transform the national accounts' data in order to make them homogeneous with tax regulations. Therefore, it is crucial to rely on highly detailed information, since more specific regulations call for further detail.

The Administration uses the following information groups in its calculation:

1. Final consumption by households (261 items);
2. Intermediate consumption by government (17);
3. Intermediate consumption by non-profit institution serving households;
4. Intermediate consumption by industry (58);
5. Intermediate consumption by product (5);
6. Gross fixed capital formation by government (11);
7. Gross fixed capital formation in dwellings (new and improvements);
8. Gross fixed capital formation by other market sector (58);
9. Valuables.

The tax under consideration enables to draft sufficiently extensive historical series; in the case of Italy, reliable information is available as from 1980. Likewise, the calculation methodology enables to perform estimations in brief terms. Therefore, the potential VAT base is used to perform long-term analysis as well as considerations on the most recent evolution of regulatory compliance.

As regards the structural analysis, an econometric estimation was conducted, which tends to isolate the context variables that influence evasion, in order to capture the Administration's specific role¹⁴. Empirical evidence confirms that there is an important positive relation between the system's tax rates and tax evasion. The positive correlation between evasion and the economic cycle is also less intuitive, in the sense that evasion tends to drop in the recessive stages of the cycle and to grow in the expansion stages. This relation may be explained by the behavior of marginal companies operating partially or fully in the informal market; since they are also weaker they tend to be the first to be expelled from the market in times of crisis. Upon isolating the structural factors, we identify that taxpayers perceive a negative relation with the Administration's control power.

3.2. Regional Tax on Productive activities (IRAP).

The studies performed on VAT fail to render detailed information by economic activity and geographical area. Therefore, we have used the IRAP, a relatively recent tax created in 1997. This tax assumes the regular regional undertaking of activities organized autonomously for the production or exchange of goods or rendering of services.

The features of this tax are:

- A large taxpayer universe spanning the operators comprised in the assessment of the GDP almost in full;
- A tax base that is very similar to the value added to the cost of the national accounts' factor;
- Regional articulation performed on the basis of the production carried out in the location.

The three above-mentioned features facilitate comparison with the national accounts' data and enable detailed analyses both from the sectoral and territorial perspectives¹⁵.

The analysis of the supply enables, on the one hand, to divide the taxpayer universe on the basis of business size.

¹⁴ For a summary of the general evasion data, refer to Androni et al. (1998) and Christie E., Hozner M. (2006). Specifically for VAT, refer to Keen; Smith (2007), Nam et al. (2001).

¹⁵ For further information on the methodology, refer to Pisani, Polito (2006).

Finally, on the basis of the IRAP, we may distinguish between the evasion component generated by informal labor and the one stemming from other types of fraud.

The Administration employs such estimations mainly for territorial analyses, to identify the areas with highest tax criticality as well as the sectors with the highest exposure to tax evasion risk, considering the area where they belong. In particular, we rely on information that subdivides the national territory into 102 provinces, within which six economic activity sectors are detailed¹⁶.

4. CONCLUSIONS

This paper described the sources and methods of the key indicators applied by the Administration to estimate the tax gap and set forth a number of notions on how such information is used to plan and schedule the Administration's activity.

The methods use the top-down approach and are based on the comparison with macro-economic aggregates, which is extremely useful to provide a general benchmark framework of the system's structure and evolution.

Considering that evasion is a typically underlying variable and one which is particularly complex to estimate, it is necessary to use several independent estimations in order to undertake a reliability analysis based on the observation of the results obtained.

More than an end, it is the starting point for future actions. In order to attach greater operating value to the indications obtained from the top-down approach, we must integrate them with bottom-up techniques, based on the use of the results of tax controls¹⁷, in order to better qualify the information by type of taxpayer (for example, differentiating individuals from corporations) and extend the types of taxes that may be affected by tax evasion (for example, income tax).

Once the database is fine-tuned, we must analyze the grounds for evasion, in order to neutralize the effect of the scenario variables and isolate the role of the Tax Administration in reducing the tax gap, and therefore, increasing voluntary compliance. The latter variable is the most important objective in fulfilling the Administration's mission.

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¹⁶ The detail of the economic sectors is limited to a greater territorial breakdown. At the national level, estimations are conducted for 50 branches, while for the 20 regions the sectors are limited to 20.

¹⁷ Please refer to OECD (2004b).

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Strategies and Mechanisms for Controlling Evasion



The Tax Administrations and the Taxpayer's Social Responsibility: Strategies for Combating Harmful Tax Planning

Introduction

1. Laying the groundwork.
2. Combating harmful tax planning.
3. Making compliance easier.
4. Conclusion.

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INTRODUCTION

The Discussion of this paper has three parts: Laying the Groundwork, Combating Harmful Tax Planning and Making Compliance Easier.

- Laying the Groundwork covers the International Planning and Operations Council and how it takes a servicewide approach to international tax administration and budget formulation. It also covers testimony by the IRS Commissioner and the Treasury Secretary to gain the funding necessary for the Service's offshore compliance programs. Finally, there is a discussion of a multi-year consolidation of international compliance efforts within the IRS.
- Combating Harmful Tax Planning discusses the IRS' efforts to obtain taxpayer information from Liechtenstein, Swiss-Based UBS and First Data Corp. It also includes information about the successful Voluntary Compliance program which took place in 2009 and the creation of a Transfer Pricing Practice within the IRS.
- Finally, Making Compliance Easier makes reference to programs discussed in the paper prepared for the October 2009 CIAT Technical Conference. These are programs aimed at providing taxpayers with certainty sooner through increased transparency on the part of the taxpayer and the IRS.

Discussion

1. LAYING THE GROUNDWORK

International Planning and Operations Council – a Servicewide Approach to International Tax Administration

Several years ago, Commissioner Mark Everson and other key executives looked across the Internal Revenue Service (IRS) and saw that international tax administration was not limited to the International organization in the Large and Mid-Sized Business Division (LMSB). It was, in fact, Servicewide: one operating division handled processing and customer service, another was responsible for international individuals and international small businesses and another for international pension arrangements and charities. In addition, Appeals, Criminal Investigation and Counsel – all separate organizations within the Internal Revenue Service (IRS) – each had responsibility for various aspects of international tax administration. Meanwhile, globalization was clearly on the rise — overseas travel, investment, shopping, employment and outsourcing are commonplace events today. The acceleration of globalization meant the IRS' tax administration operations had to be prepared to serve an expanded taxpayer base with cross-border transactions. It was evident the IRS needed a more coordinated approach to international tax administration.

To deal with this situation, Frank Ng, then Deputy Commissioner International in LMSB, created the International Planning and Operations Council (IPOC), composed of executives from each of the IRS business units (Wage and Investment, Small Business and Self Employed and Tax Exempt and Government Entities) along with executives from Appeals, Criminal Investigation and Counsel. At the January 23, 2007 launch of the IPOC, both he and LMSB Commissioner Deborah Nolan spoke to Commissioner Everson's high level interest in international tax issues. The IPOC accepted the challenge to take a coordinated effort across the Service and developed a multiyear plan, the Servicewide Approach to International Tax Administration (Servicewide Approach). The thrust of the Servicewide Approach was to integrate and strengthen existing international expertise, programs and activities located in the various parts of the IRS. The members of the IPOC meet every other month. As expected, the active involvement of all IRS business units has made it easier to improve taxpayer assistance, enhance enforcement and modernize the organization to assure the achievement of international tax administration goals. The Servicewide approach, i.e., the unified plan, was an important first step in improving international tax administration and positioning IRS to meet the challenges of globalization.

After Barry B. Shott became the Deputy Commissioner International, he took the Council one step further. At the November 2007 meeting of the IPOC, he charged them to link their FY2010 international budget requests to specific goals in the Servicewide Approach. They were to be quite specific about why they needed the money, e.g., increased staff, equipment, computer programming. He formed a sub-team which met and identified four main areas of focus: increased staffing; training (new and experienced employees); information reporting, information processing, using information technology and taxpayer service. His goal was to institutionalize international within the IRS by embedding it in the budget. He urged Council members to describe, not just what was attractive, but what was deliverable and to clearly articulate what they wanted to do. Each operating division prepared its own budget but included a cross-functional reference back to the Servicewide Approach. This had the desired effect of making this new way of dealing with globalization more visible within the IRS. As they set to work, everyone knew this was a time when government budgets were likely to go down, not up.

By March, the Council sent to the IRS' Chief Financial Officer (CFO) a unified FY 2010 request for more than \$100,000,000 (\$100M) to fund 676 positions focused on international issues. This included hiring international examiners, economists, revenue agents and tax compliance officers with \$3,400,000 earmarked for training. It also included increasing focus on combating offshore activities; expanding Criminal Investigation's overseas presence; improving processing of information documents the Service receives; as well as funding for Appeals and Counsel to support increased activities in other parts of the IRS.

From the very beginning of his appointment in early 2008, Commissioner Shulman took a strong interest in international tax administration including providing additional funding for FY09. In November 2008, Deputy Commissioner International Barry B. Shott announced that during FY09, LMSB would hire 200 new employees for international issues: 40 International Examiners, 40 Economists and 20 Financial Products Specialists who came onboard beginning at the end of the 2nd quarter. These LMSB employees were to focus on corporate taxpayers in the area of transfer pricing and other international issues. At the same time, the Small Business Self Employed (SBSE) operating division got the OK to hire an additional 150 employees to focus on high income/high wealth individual taxpayers.

In April 2009 the IRS learned the President's budget request included the FY2010 international initiatives that all IRS offices had worked on. The final figure was actually more than requested – approximately \$126,000,000 (\$126M) budgeted instead of the \$100,000,000 (\$100M) requested. But with increased funding came increased expectations, i.e., there is an expectation of \$210,000,000,000 (\$210B) in additional revenue over 10 years. This will require legislative changes and non-traditional compliance work.

Senate Finance and Appropriations Committee Testimony

The IRS relies heavily on voluntary compliance but recognizes there are taxpayers who, not only do not willingly comply, they deliberately engage in tax planning designed to evade tax – harmful tax planning from a tax administration point of view. Beginning with his initial testimony at the January 29, 2008 Senate Finance Committee hearing on his nomination as Commissioner, Douglas Shulman set the tone for his tenure as IRS Commissioner when he said:

For taxpayers who pay their taxes willingly and on time, which is the great majority of Americans, there must be clear guidance, accessible education, and outstanding service. Our aim should be to make it as easy as possible for them to pay the correct amount of taxes in the most efficient and least burdensome manner possible. For taxpayers who intentionally evade paying their taxes, there must be rigorous enforcement programs.¹

¹ Shulman, Douglas H., *Testimony of Douglas H. Shulman before the Senate Finance Committee on Nomination to Become the Commissioner of Internal Revenue, HP-783, Washington, D.C., January 29, 2008. HP-783*

At the July 24, 2008 U.S. Senate Finance Committee Hearing on Tax Haven Financial Institutions: Their Formation and Administration of Offshore Entities and Accounts for Use by U.S. Clients, LMSB Commissioner Frank Ng testified about a variety of initiatives aimed at improving compliance and drew the Committee's attention to the Servicewide Approach he created to integrate the international perspective into IRS business division strategies and processes. When he summed up the international challenges faced by the Service, he laid the groundwork for a high level of support from the Senate and hinted at the need for a restructuring which took place in October 2009:

...there is no longer a bright line that can be drawn between international and domestic tax issues. With increasing globalization, virtually every large business return – as well as the returns of many small companies and even individuals – has international features due to the ease of cross-border transactions²

In June 2009, IRS Commissioner Shulman and Treasury Secretary Timothy Geithner testified before a panel of the Senate Appropriations Committee. He continued the idea expressed in his nomination hearings, i.e., honest taxpayers who pay their fair share of taxes want the government to take action against those who don't. He said:

The American people who play by the rules every day expect the IRS to pursue those taxpayers who do not pay their taxes, and we are vigorously enforcing the tax law. We are focusing on current enforcement initiatives, such as in the international arena, while seeking to evolve and innovate.³

Both urged a Senate appropriations panel to support President Obama's FY 2010 budget request to fund key tax priorities in FY10.

Recent Restructuring

For a number of years the IRS has been observing some unmistakable trends in the international tax arena, including significant increases in cross-border transactions, transfer pricing and foreign tax credit filings, the use of flow-through entities, and tremendous growth in the number of U.S. citizens and small businesses abroad and non-citizens working in the U.S. These trends require that the IRS strengthen its focus on international tax administration. The President, Treasury Secretary and IRS Commissioner each have underscored the urgency of stepping up our international tax compliance activities. In October 2009, the IRS launched the Large Business and International Expansion (LB&IE) initiative. Two key work streams within that initiative were:

- the High Wealth/High Income Industry in LMSB (with taxpayers in this group including individuals); and
- completing the task of bringing all of the Service's international compliance activities under one roof (foreign resident and international small business compliance).

High Wealth Industry

On October 7 and 8, 2008, Deputy Commissioner International, Barry B. Shott, hosted an international conference to discuss the movement of money and how that impacts tax administration. The invitations included all IRS operating divisions as well as external banking regulators, U.S. Government enforcement agencies (e.g., Department of Justice, FINCEN), Tax Executives Institute (TEI), major accounting firms, members of OECD Banking Intermediary Study Team, Treasury and others – about 95 participants altogether. The goal was to find out what externals were seeing that could affect international tax administration. Plans included a series of panel discussions including how high wealth individuals

² Shulman, Douglas H., *Statement from IRS Commissioner Doug Shulman on Offshore Income*, March 26, 2009.

³ Shulman, Douglas H. *Written Testimony of Douglas H. Shulman Commissioner of Internal Revenue before the Senate Appropriations Committee Subcommittee on Financial Services and Government on FY 2010 IRS Budget*, Washington, D.C., June 9, 2009.

structure their finances (as corporations or as individuals). Day 1 was for internal/external stakeholders. Day 2 was only for internal stakeholders and included facilitated discussions of what they heard on Day 1. IRS learned that the behavior of high wealth individuals is more like corporate behavior than it is like individual behavior.

Concurrently, the IRS' Examination Enforcement Government Council (EEGC), another council with members from across the IRS, had been looking for a way to establish priorities for strategies around Abusive Tax Avoidance Transactions, the Earned Income Tax Credit, non-filers and the tax gap. This Council's High Income/High Wealth team conducted a review of cases that had come through the enforcement/exam pipeline to understand compliance risks. They looked at the taxpayer's entire enterprise, i.e., all entities related to a particular taxpayer instead of simply looking at the individual entity.

As part of the October 2009 restructuring IE, IRS brought SBSE's High Wealth/High Income (GWHI) initiative to LMSB as a new Industry to work alongside LMSB's existing five Industries. The strategies of this group include:

- Refine a risk assessment process for global high wealth enterprises;
- Establish a format for comprehensive case building;
- Conduct examinations of GHW individuals and related enterprises;
- Centralize IRS expertise on global high wealth compliance risk into a single organizational entity.

Foreign Resident and International Small Business Compliance

Late in 2007, IRS brought SBSE's Foreign Resident Compliance function to LMSB International. This represented a big change to LMSB's view of its taxpayer profile. No longer were LMSB's taxpayers limited to businesses with assets of \$10,000,000 or more. They also included:

- U.S. citizens residing overseas or in U.S. Territories;
- Lawful permanent residents (green card holders) in the U.S;
- Small businesses maintaining books and records overseas;
- Non-resident aliens and foreign corporations in the U.S.;
- U.S. expatriates who gave up their citizenship;
- Individuals with tax treaty issues or other international features.

The October 2009 restructuring continued this effort by bringing into LMSB International additional SBSE international initiatives affecting individuals and small businesses:

- Abusive Tax Avoidance Transaction Offshore Field Groups and Headquarters;
- Offshore Compliance Initiative team; and
- Central Withholding Agreements (CWA) Group.

The target completion for the full integration of these functions is October 2010.

The goals are simple:

- Improve consistency of international and offshore compliance operations;
- Increase coverage of international and offshore compliance;
- Enhance customer service.

2. COMBATING HARMFUL TAX PLANNING

Liechtenstein

In mid-February 2008, a news story broke that attracted the attention of tax administrations around the world. The German government had received information on German citizens who were involved in a multi-billion-euro tax evasion scandal involving its citizens who were hiding assets in Liechtenstein banks.

By the end of February 2008, tax administrations in Australia, Canada, France, Italy, New Zealand, Sweden, United Kingdom, the U.S. others, all member countries of the OECD's Forum on Tax Administration (FTA), began working together concerning Liechtenstein accounts being used for tax avoidance and evasion. Within a few days of each other, news and press releases went out around the world:

Tax commissioners battle against tax evasion (Australia and UK)⁴

Agenzia Entrate ha ricevuto informazioni su italiani con depositi in Liechtenstein (Italy)⁵

Tax authorities work together to stop international tax evasion (NZ)⁶

IRS and Tax Treaty Partners Target Liechtenstein Accounts (US)⁷

In the U.S., the IRS began enforcement action involving more than 100 U.S. taxpayers to ensure proper income reporting and tax payment in connection with accounts in Liechtenstein. Some countries, such as New Zealand, offered penalty relief programs under their voluntary disclosure rules.⁸

By December 8, 2008 the U.S. and Liechtenstein had a signed Tax Information Exchange Agreement (TIEA). In October 2009, Liechtenstein and U.S. representatives met to discuss implementing legislation necessary to bring the TIEA into force as of January 1, 2010. This TIEA is Liechtenstein's first to enter into force and the only one in force for 2010. It will have effect for requests for information made for tax years beginning on or after January 1, 2009 for both civil and criminal tax matters.

UBS

On June 30, 2008, the U.S. Justice Department filed a petition for permission to issue a "John Doe Summons" to request information from Zurich Switzerland-based UBS about U.S. taxpayers who may be using Swiss bank accounts to evade federal income taxes. The next day a federal judge in Miami, Florida issued an order authorizing the IRS to request information from Zurich, Switzerland-based UBS AG about U.S. taxpayers who may be using Swiss bank accounts to evade federal income taxes. The IRS uses a John Doe summons to obtain information about possible tax fraud by people whose identities are unknown. Internal Revenue Manual (IRM) 25.5.7.1 defines this kind of summons as follows:

A John Doe Summons is any summons where the name of the taxpayer under investigation is unknown and therefore not specifically identified. A John Doe summons can only be served after approval by a Federal court. Therefore, the Service must never serve a "friendly" John Doe summons

⁴ *Australian Tax Office Media Release and HM Revenue and Customs News Release, Tax commissioners battle against tax evasion, February 26, 2008.*

⁵ *Agenzia Entrate Comunicato Stampa, Agenzia Entrate ha ricevuto informazioni su italiani con depositi in Liechtenstein, February 26, 2008.*

⁶ *Inland Revenue Te Tari Taake Media Release, Tax authorities work together to stop international tax evasion, February 27, 2008.*

⁷ *IR-2008-26, Internal Revenue Service News Release, IRS and Tax Treaty Partners Target Liechtenstein Accounts, February 26, 2008.*

⁸ *IR-2008-26, Internal Revenue Service News Release, IRS and Tax Treaty Partners Target Liechtenstein Accounts, February 26, 2008, and Inland Revenue Te Tari Taake Media Release, Tax authorities work together to stop international tax evasion, February 27, 2008.*

even though a prospective summoned party may request one as a condition to providing information to the Service. Serving a John Doe summons without court approval violates the statute and will jeopardize the investigation.⁹

The U.S. became interested in UBS, in part, because of a statement submitted to the court by former UBS banker Bradley Birkenfeld. Birkenfeld said UBS employees assisted wealthy U.S. clients in concealing their ownership of assets held offshore by creating sham entities and then filing IRS forms falsely claiming that the entities were the owners of the accounts. According to Birkenfeld's court statement, UBS had approximately \$20 billion of assets under management in "undeclared" accounts for U.S. taxpayers.¹⁰

After filing the Summons, the U.S. and the Justice Department began discussions to seek cooperation of the Swiss government. On August 19, 2009, the Justice Department and the IRS announced that the agreement with the Swiss government has been finalized. As a result of the agreement, the United States will receive substantially all of the accounts of interest when it initiated the John Doe summons against UBS on June 30, 2008.

The agreement involved a number of simultaneous legal actions:

- The judicial enforcement of the John Doe summons was be dismissed in a way that left the underlying John Doe Summons in effect;
- Upon receiving the treaty request, the Swiss government directed UBS to notify account holders over the course of several months that their information was included in the I.R.S treaty request;
- Receipt of this notice did not by itself preclude the account holder from coming into the IRS under the Voluntary Disclosure Program, which ended Sept. 23, 2009.

In addition, the Swiss Government has agreed to review and process additional requests for information from other banks regarding their account holders to the extent that such a request is based on a pattern of facts and circumstances equivalent to those of the UBS case.

Finally, the agreement retained the U.S. Government's right, if the results are significantly lower than expected and other measures fail, to seek appropriate judicial remedies, including resuming actions to enforce the John Doe summons.¹¹

Right now the IRS is at the beginning stages of implementing the agreements with the Swiss Government and UBS. By the end of 2010, IRS expects to receive information about approximately 7,500 accounts.

Voluntary Disclosure Program

On March 26, 2009, the IRS announced a short-term program intended to provide a reduced penalty regime as well as immunity from prosecution if taxpayers met certain conditions. The program featured paying:

- Back-taxes and interest for six years;
- An accuracy or delinquency penalty on all six years;
- A penalty of 20 percent of the amount in the foreign bank accounts in the year with the highest aggregate account or asset value anytime in the past six years.

⁹ Internal Revenue Service, *Internal Revenue Manual 25.5.7.1, September 1, 2006.*

¹⁰ *The United States Department of Justice, Office of Public Affairs, Federal Judge Approves IRS Summons for UBS Swiss Bank Account Records, July 1, 2008.*

¹¹ *The United States Department of Justice, Office of Public Affairs, U.S. Discloses Terms of Agreement with Swiss Government regarding UBS, August 19, 2009.*

The driver for this program was a growing sense that a very significant number of persons with a U.S. filing, paying or reporting requirement were not declaring the existence of their off shore accounts nor were they reporting the income from them. The program was designed to give taxpayers – and tax practitioners – certainty and consistency in how their case would be handled.¹²

Three guidance memos went out: how to handle offshore cases¹³; routing voluntary disclosures for action¹⁴; penalty framework to assure consistency¹⁵. The landing page of irs.gov featured a “rotating spotlight” to draw attention to the program and to an initial set of Frequently Asked Questions due to the high volume of questions IPOC members reported getting at conferences they attended.

Initially, the deadline was September 26, 2009 but, because many practitioners reported being overwhelmed with last-minute client requests to participate, IRS extended the deadline to October 15, 2009.

The Voluntary Disclosure program gave people a special chance to come in and get right with the government. Taxpayers took advantage of it in record numbers – more than 14,700 people who hadn't been reporting offshore assets and income are coming back into compliance.

The unprecedented agreement with the Swiss authorities reached in August 2009 regarding UBS account holders – and the response to the special offshore voluntary disclosure program – together represent an historic milestone. They proved to the world – especially to account holders, promoters and banks – that the IRS is serious about:

- its international efforts;
- piercing the veil of bank secrecy; and
- carrying forward the momentum to address offshore tax evasion.

IRS is currently mining the 14,700 voluntary disclosures for information to identify financial institutions, advisors, and others who promoted or otherwise facilitated US persons hiding assets and income offshore and attempting to shirk their tax responsibilities at home.

The response to the voluntary disclosure program will have ramifications extending far beyond 2009. It will change the conversations that practitioners and tax return preparers will be having with many of their clients – especially during tax filing season. Those taxpayers who sought advice from advisors, but chose not to come forward in the voluntary disclosure program, will once again have to confront whether they come clean and properly report these accounts.¹⁶

First Data Corporation

On April 13, 2009, the Department of Justice asked a federal court in Denver to approve service of a John Doe summons on First Data Corporation for information to help the IRS identify merchants who use offshore accounts to evade their U.S. tax liabilities. The petition alleged that the merchants opened bank accounts in offshore jurisdictions and directed their payment card processor, in this instance First Data, to deposit the proceeds from their debit or credit card transactions directly into offshore accounts. With this summons, the Department of Justice ratcheted up the pressure on tax evaders by seeking the

¹² Shulman, Douglas H., *Statement from IRS Commissioner Doug Shulman on Offshore Income*, March 26, 2009.

¹³ Fink, Faris R., Shott, Barry B., and Song, Victor, *Routing of Voluntary Disclosure Requests*, March 23, 2009.

¹⁴ Fink, Faris R., Shott, Barry B., and Song, Victor, *Emphasis on and Proper Development of Offshore Examination Cases, Managerial Review, and Revocation of Last Chance Compliance Initiative*, March 23, 2009.

¹⁵ Stiff, Linda E., *Authorization to Apply Penalty Framework to Voluntary Disclosure Requests Regarding Unreported Offshore Accounts and Entities*, March 23, 2009.

¹⁶ IR-2006-116, *Prepared Remarks of Commissioner Douglas Shulman before the 22nd Annual George Washington University International Tax Conference*, Washington, D.C., December 20, 2009.

identities of merchants who attempt to hide their business income in offshore accounts.¹⁷ By April 15, 2009, a Colorado Court issued the summons.

In September 2009, First Data Corp. agreed to comply with a modified IRS summons seeking businesses that may be hiding income in offshore accounts. The modified summons reduced disclosure requirements.

Transfer Pricing Practice

Starting in the fall of 2008 and into 2009, a team from across the country, made up of domestic and international managers, field specialists, technical advisors, competent authority, field counsel, APA and LMSB International looked at ways to rethink IRS' approach to transfer pricing.

They developed a set of short and long term recommendations that were presented to LMSB leadership. The recommendations were grouped as:

- Organize to better support transfer pricing operations;
- Build a team of transfer pricing experts to improve issue development and resolution;
- Improve leverage of transfer pricing expertise;
- Incorporate transparency strategies and incentives to improve taxpayer compliance;
- Improve issue identification and case selection to focus on significant areas of non-compliance;
- Ensure field accountability through transfer pricing goals and measures.

The Service has already implemented some of these recommendations, including hiring additional specialists who will play a key role in transfer pricing exams, and establishing the Transfer Pricing Council in January 2009.

The Transfer Pricing Council is comprised of executives from LMSB and Chief Counsel, and focuses on coordination of transfer pricing strategies and policies. It is a forum for gathering and sharing information from key areas within IRS that deal with international transfer pricing matters. The Council meets every 4 to 6 weeks to address high-level issues, e.g., strategy, resource allocation, coordination, tools our employees require, gaps in guidance and forthcoming changes in law. The Council recommends guidelines to stakeholders for transfer pricing strategic decisions, resources, commitments and outcomes. The Council does not have case or issue control, nor does it get into the business of reviewing cases.

Right now, a team is working on the design and implementation planning for the Transfer Pricing Practice. This is to improve IRS' capability to strategically and systematically administer transfer pricing issues. The idea is to create a group of experts in the transfer pricing area who will coordinate the handling of issues that are most important to taxpayers and to the IRS, identify emerging issues and trends, and provide consistency in developing and resolving transfer pricing cases. This group will help examination personnel throughout the organization by providing technical expertise as needed, assist in the development of new risk assessment techniques to better identify the taxpayers and issues with the greatest risk, and develop examination best practices to ensure optimal resource allocation.

IRS' goal with the establishment of the Transfer Pricing Practice is to significantly improve how it addresses transfer pricing issues in the future, with a focus on interactions with taxpayers, development of issues, and consistent resolution.

¹⁷ *The United States Department of Justice, Office of Public Affairs, Department of Justice Asks Court to Serve Summons for Offshore Records, April 15, 2009.*

3. MAKING COMPLIANCE EASIER

“Creation of Large Taxpayer Units and the Inclusion of Large Individual Taxpayers” prepared for the CIAT October 2009 Technical Conference included a discussion of programs IRS has implemented to make compliance easier:

LMSB’s overall strategy depends on two things: currency (certainty sooner) and transparency, i.e., completing examinations in an efficient and timely manner, while reconciling the book-tax differences and risks. Today, IRS has an established foundation that will result in better service to large taxpayers and a greater ability to conduct its compliance responsibilities more effectively and in a timely manner. LMSB has identified challenges and has initiated several programs that foster transparency, currency, pre-filing compliance opportunities and improved efficiencies in issue and risk identification.¹⁸

One of the programs to assure certainty sooner is Fast Track Settlement. The Fast Track Settlement program (FTS) offers a customer-driven approach to resolving tax disputes at the earliest possible stage in the examination process. LMSB made this process permanent in 2003.

Another program is the Compliance Assurance Process (CAP) introduced in LMSB in 2005. CAP, is a pre-filing compliance assurance process, focusing on issue identification and resolution through real-time taxpayer interaction. Under CAP, a taxpayer works cooperatively with LMSB Revenue Agents in a pre-filing environment to resolve issues of tax controversy and to determine the proper tax treatment of completed transactions.

When LMSB stood up in October 2000, the Pre-Filing Agreement program was a groundbreaking feature of IRS’ new ways of doing business. This program encourages taxpayers to request consideration of an issue before the tax return is filed and thus, resolve potential disputes and controversy earlier in the examination process. The program reduces the cost and burden associated with the post-filing examination, provides a desired level of certainty regarding a transaction and makes better use of taxpayer and IRS resources.

4. CONCLUSION

The Internal Revenue Service has long relied on the voluntary compliance of taxpayers to fulfill its mission: “Provide America’s taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.”

The IRS has programs in place to make compliance easier for those taxpayers who want to comply. Many of those taxpayers also want certainty sooner. The IRS is committed to offering taxpayers certainty sooner through increased transparency on the part of the IRS as well as on the part of the taxpayers.

These same taxpayers also want everyone to pay their fair share of tax. The programs to make compliance easier coupled with stepped up offshore enforcement efforts combine to build the foundations needed to improve voluntary compliance in support of the IRS mission.

¹⁸ O’Donnell, Douglas, *Creation of Large Taxpayer Units and the Inclusion of Large Individual Taxpayers*, CIAT Technical Conference, October 2009.



Information Exchange and Administrative Assistance for Recovery as Effective Mechanisms for Controlling Fraud, Evasion and Avoidance

- I. Mechanisms developed by the OECD for effective exchange of information and administrative assistance for tax collection.
 1. The international standards of transparency and exchange of information for tax purposes are now accepted by countries around the world.
 2. Next steps.
 3. The legal mechanisms for exchange of information.
 4. Forms of exchange of information.
 5. Setting standards on assistance in tax collection.
- II. Improving efficiency and effectiveness

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I. MECHANISMS DEVELOPED BY THE OECD FOR EFFECTIVE EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE FOR TAX COLLECTION

1. The international standards of transparency and exchange of information for tax purposes are now accepted by countries around the world

The international standards require:

- Exchange of information on request where it is “foreseeably relevant” to the administration and enforcement of the domestic laws of the treaty partner.
- No restrictions on exchange caused by bank secrecy or domestic tax interest requirements.
- Availability of reliable information and powers to obtain it.
- Respect for taxpayers’ rights.
- Strict confidentiality of information exchanged.

These standards are set out in the 2002 Model Agreement on Information Exchange on Tax Matters developed by OECD and non-OECD countries working together, in Article 26 of the OECD Model Tax Convention and the recently revised Article 26 of the UN Model Tax Convention. They have been endorsed by the EU, the G7/8, and the G20.

Since the beginning of 2009, international tax evasion and the implementation of the above standards have been very high on the political agenda, reflecting recent scandals that have affected countries around the world, the spotlight that the global financial crisis has put on financial centres generally, and the April 2009 G20 London Summit.

At its London Summit, the G20 declared “the era of banking secrecy is over” and agreed to take action against non-cooperative jurisdictions. This heightened political attention has led to a number of significant and positive developments among financial centres since the April meeting:

- All OECD countries have now endorsed the standard and are in the process of up-grading their existing treaties or negotiating new treaties to meet the standards. Over 70 Tax Information Exchange Agreements (TIEAs) have been signed, 20 in the last month and over 60 tax treaties have been negotiated or renegotiated to meet the standard.
- Hong Kong, China and Singapore have endorsed the standard and have tabled legislation.
- Macao, China has already passed legislation that will enable it to engage in effective exchange of information.
- Chile, Costa Rica, Guatemala, Malaysia, Philippines and Uruguay are taking steps to meet the standards.

2. Next Steps

Tackling tax evasion is not, however, simply a matter of endorsing a standard. The standards will only allow countries to effectively enforce their tax laws when implemented in practice. The G8 Finance Ministers, at their recent meeting on 13 June 2009, urged further progress in the implementation of the OECD standards, encouraged the involvement of the widest number of jurisdictions, including developing countries and suggested the development of an effective peer review mechanism to assess compliance with the standards. The Global Forum on Transparency and Exchange of Information (GFTEI) at its meeting in Mexico on 1-2 September 2009 agreed on ways to speed up the implementation process,

broaden participation in its work and ensure effective compliance with the standards. It agreed to:

- Restructure the Global Forum to expand its membership and ensure its members participate on an equal footing;
- Launch an in-depth peer review and quickly implement it; and
- Identify mechanisms to speed-up the negotiation and conclusion of agreements to exchange information and to enable developing countries to benefit from the new more cooperative tax environment.

3. The Legal Mechanisms for Exchange of Information

Article 26 of the OECD Model Tax Convention

The most commonly used legal mechanism is Article 26 of the OECD Model Tax Convention on Income and on Capital, which provides for exchange of information in the context of a comprehensive bilateral income tax treaty. Over 3000 bilateral tax treaties are based on the OECD Model Tax Convention. Article 26 sets forth the rules under which information may be exchanged between tax authorities. It does not limit the form of such exchanges, although the main forms used are on request, automatic and spontaneous exchange. Article 26 first establishes the obligation to provide information to a treaty partner and the circumstances under which this obligation exists. It then sets out rules that ensure that any information provided to a treaty partner is subject to strict confidentiality that protect the legitimate privacy rights of any person to whom the information relates. Finally, it provides certain exceptions from the obligation to provide information, but notes specifically that grounds for declining a request can not be based on bank secrecy or the absence of a domestic tax interest in the information. Following the recent withdrawal of reservations by Austria, Belgium, Luxembourg and Switzerland in March 2009, Article 26 has the support of all OECD members.

The Convention on Mutual Administrative Assistance in Tax Matters

This multilateral instrument was developed jointly by the OECD and the Council of Europe. It provides for exchange of information for a wide range of taxes as well as other forms of mutual assistance such as assistance in the collection of taxes and the service of documents. The Convention is currently in force with respect to the following 14 countries: Azerbaijan, Belgium, Denmark, Finland, France, Iceland, Italy, the Netherlands, Norway, Poland, Sweden, the Ukraine, the United Kingdom and the United States. There is a growing interest in the Convention particularly as it allows for exchange of information for consumption tax purposes, assistance in tax collection, but also for multilateral exchange and in particular multilateral simultaneous tax examinations. Canada and Germany are still in the process of ratifying the Convention. A revision of the Convention is being undertaken to bring it up to the international standard and opening the Convention up to more countries is also under consideration.

2002 Model Agreement on Information Exchange on Tax Matters

This model was developed in partnership with non-OECD jurisdictions committed to the principles of effective exchange of information and transparency in the context of the harmful tax practices project described above. It is designed as a model for TIEAs outside the context of comprehensive income tax treaties, and has been used extensively. Unlike Article 26 and the Convention on Mutual Administrative Assistance in Tax Matters, it is limited to exchange of information on request. CIAT has a similar model.

Other instruments:

Within the European Community Directive 77/799/EEC as updated, for exchange of information for VAT purposes, Regulation No 1798/2003 and for excise duties, Regulation No 2073/2004. A new proposed Directive C/2009/29 on administrative cooperation in the field of taxation is presently being discussed which specifically states that grounds for declining a request cannot be based on bank secrecy or the absence of a domestic tax interest in the information.

International judicial assistance agreements, such as the Inter-American Convention on Mutual Assistance in Criminal Matters (as extended by the Optional Protocol of May 23, 1992) in cases of tax crimes.

Procedures for providing assistance to foreign jurisdictions may also be established in domestic law. For instance, some countries permit the provision of information to another jurisdiction, subject to certain conditions and safeguards (e.g. reciprocity and confidentiality of information), even in the absence of an international agreement and solely based on their domestic law provisions.

The provisions on exchange of information do not allow for assistance in tax collection in the sense of empowering the competent authorities to use their powers of collection on behalf of the other contracting party. However, they include information exchange for “collection of taxes” and thus information assisting in the collection of domestic taxes can be exchanged between contracting parties. Such information could be useful in cases where a taxpayer is seeking a reduction of the tax assessed on the basis that he has insufficient funds to pay the full amount of tax owed. An exchange of information agreement would enable the tax authority to verify whether the taxpayer had assets abroad.

4. Forms of Exchange of Information

All forms of exchange are relevant for controlling tax fraud, avoidance and evasion. The main ones are described below.

Exchange of information on request. Exchange of information on request refers to a situation where the competent authority of one country asks for particular information from the competent authority of another contracting party.

Example : Import and export transaction using conduit companies

Resident company T purchases electronic components for use in its manufacturing operations from company C, resident in B. A tax inspector auditing company T becomes suspicious because the price charged by C to T far exceeds comparable prices in the industry. The tax inspector suspects that the amount invoiced is significantly higher than the amount C pays to the producer of the components. The tax inspector further suspects that in reality company C acts as an agent and that its likely paper profits are paid to a third party related to company T.

Via his competent authority the tax auditor may request:

- Information about direct imports/exports or the imports/exports via C (invoices of the forwarding agents, customs documents);
- Information about size and operation of C’s premises and warehouses (e.g. copy of the lease showing size of premises and any rental payments due);
- Information about number of employees of C;
- Information about the persons acting for C, their remuneration, actual salary and social security payments;
- Accounting records/financial statements for C;
- If C claims to be an independent agent: information about the persons acting as agent, names and addresses, their remuneration, proof of the actual salary and social security payments made.

Based on the information provided by the competent authorities of country B the tax inspector is able to prove that company C deposited the difference between the purchase and the sales price (minus a small fee) into an account which A, the sole shareholder of T, has with a bank resident in B. A had not disclosed these payments in his income tax return.

Spontaneous exchange of information. Information is exchanged spontaneously when one of the contracting parties, having obtained information in the course of administering its own tax laws which it believes will be of interest to one of its treaty partners for tax purposes passes on this information without the latter having asked for it. A spontaneous exchange of information is usually effective since it concerns particulars detected and selected by tax officials of the sending country during or after an audit or other type of tax investigation.

Example: An audit of company X in country A reveals a payment of €40,000 for management fees paid to an unrelated company Y in country B. An examination of the invoices indicates this amount was paid to company Y but an examination of the company X bank account shows two deposits made on the same day, one for an amount of €25,000, the other for €15,000. The auditor observes an entry made in the managing director's diary that states, "Bill Z (the individual who provided the management services) requests payment of €25,000 into the company Y bank account and €15,000 into the Bill Z bank account". Suspecting the second amount may not be disclosed in the accounts of company Y and believing the information could therefore be of use to the tax administration in country B, the auditor initiates a spontaneous exchange of information with country B via the competent authority.

Automatic exchange of information. Automatic exchange of information involves the systematic and periodic transmission of large volumes of taxpayer information by the source country to the residence country concerning various categories of income (e.g. dividends, interest, royalties, salaries, pensions, etc). This information is obtained on a routine basis in the source country (generally through reporting of the payments by the payer (financial institution, employer etc). Automatic exchange can also be used to transmit other types of useful information such as changes of residence, immovable property transactions, VAT credit refunds¹, etc. To improve the efficiency and effectiveness of automatic exchanges of information the OECD designed in 1981 a standard paper format and later Standard Magnetic Formats or "SMF". The most recent standard is the Standard Transmission Standard which is based on XML. The OECD has also developed a Model Memorandum of Understanding for automatic exchange of information available for use by any country. Automatic exchange is increasingly used in a strategic manner to identify non filers and taxpayers for audit.

Other forms of exchange of information can be particularly useful to improve tax controls:

- **Simultaneous tax examinations.** A simultaneous tax examination is an arrangement by two or more countries to examine simultaneously and independently, each on its territory, the tax affairs of (a) taxpayer(s) in which they have a common or related interest with a view to exchanging any relevant information which they so obtain. Such examinations are particularly useful in the area of transfer pricing, VAT and in identifying tax evasion schemes involving low tax jurisdictions. The OECD has designed a model agreement for the undertaking of simultaneous tax examinations. There is a growing interest in particular in multilateral simultaneous tax examinations given the increasing multilateral dimension of tax evasion schemes and the need for international co-operation between tax administrations.

¹ These other types are not at present supported by the standard transmission formats (SMF/STF) developed by the OECD.

- **Visit abroad of authorised representatives of the competent authorities.** Travel to a foreign jurisdiction for purposes of gathering information for a particular case may be useful in certain circumstances. However, this visit has to be authorised by the foreign jurisdiction (and be permitted by the laws of the sending country), otherwise it would represent a breach of sovereignty. This presence abroad may occur in different instances. It may be at the request of the country seeking information if it is felt it will facilitate the understanding of the request and the gathering of information. It may be at the initiative of the requested competent authority to reduce the cost and burden of gathering information. In a number of countries, authorised representatives of the competent authorities of the other country may participate in a tax examination and this is often of great value to ascertain a clear picture of business and other relations a resident of a country may have with his foreign associates.
- **Industry-wide exchange of information:** An industry-wide exchange of information does not concern a specific taxpayer but an economic sector as a whole, for instance, the pharmaceutical industry or the oil industry. An industry-wide exchange involves representatives of contracting parties meeting to discuss the way in which a particular economic sector operates, the financing schemes, the way prices are determined, the tax evasion trends identified, etc. It can be useful to select taxpayers for audit within a given economic sector.

The OECD has designed a Manual on the implementation of exchange of information programmes with the input of OECD Members and non members. It is available in English, French and Spanish. It includes modules on the various forms of exchange of information. A tool kit on automatic exchange is available at www.oecd.org/ctp/eoi,

5. Setting Standards on assistance in tax collection

In 2003, the OECD Council approved the inclusion of a new **Article 27 on assistance in tax collection** in the OECD Model Tax Convention. This Article is optional and may be included in a bilateral convention where each state concludes that, based on a number of factors, they can agree to provide assistance in the collection of taxes levied by the other state. The factors considered include the importance of their cross-border investment, reciprocity, the ability of their respective administrations to provide such assistance and the similarity of the level of their legal standards, particularly with respect to the protection of the legal rights of taxpayers and more broadly human rights.

Article 27 of the OECD Model Tax Convention provides that a Contracting State is obliged to assist the other State in the collection of taxes of every kind and description, provided that the conditions of the Article are met. At present however, provisions on assistance in tax collection included in bilateral tax conventions generally concern only taxes covered by the tax conventions.

The assistance concerns tax claims i.e. any amount owed in respect of taxes covered by the assistance but only insofar as the imposition of such taxes is not contrary to the Convention or other instrument in force between the Contracting States as well as the interest, administrative penalties and costs of collection or conservancy that are related to such an amount.

The conditions under which a request for assistance in collection can be made are that the revenue claim has to be enforceable under the law of the requesting State and be owed by a person who, at that time, cannot, under the law of that State, prevent its collection. This will be the case where the requesting State has the right, under its internal law, to collect the revenue claim and the person owing the amount has no administrative or judicial rights to prevent such collection. Except with respect to time limits and priority, the requested State is obliged to collect the revenue claim of the requesting State as though it were the requested State's own revenue claim. The requesting State can ask the other State to take measures of conservancy if the revenue claim is not yet enforceable or when the taxpayer has a right to

prevent its collection. The legal obligation to supply assistance is lifted in a limited number of situations contained in paragraphs 5 of Article 27.

There are also a number of other instruments that can be used for assistance in tax collection:

- The OECD-Council of Europe Convention on Mutual Administrative Assistance in Tax Matters provides for assistance in recovery but Parties may make a reservation on this form of assistance.
- The Nordic Assistance Convention on Mutual Assistance in Tax Matters and the Joint Council of Europe/OECD Convention includes provisions on assistance in tax collection.
- Within the EU the Directive on assistance in the recovery of tax claims 2008/55/EC of 26 May 2008 compiles all the previous Directive on assistance in recovery. A proposal for a new Directive that would strengthen assistance in the recovery of tax claims C/2009/28 is presently being discussed. The OECD has designed a Manual on the implementation of assistance in tax collection. It is available in English, French and Spanish at: www.oecd.org/ctp/eoi.

II IMPROVING EFFICIENCY AND EFFECTIVENESS OF EXCHANGE OF INFORMATION AND ASSISTANCE IN TAX COLLECTION

Given the increased importance of exchange of information and assistance in tax collection globally, the OECD has been examining how this work can be made more efficient and effective. The key resources already available are the manual on implementing exchange of information and on assistance in tax collection mentioned above. Tax administrations can benefit from that material when setting up or reviewing their arrangements for exchange of information and assistance in tax collection work. Some guidance notes have also been issued such as a Guidance Note on Encouraging and Promoting Spontaneous Exchange of Information and on on Effective Exchange of Information Training and Awareness Strategies.

1. Improving Exchange of Information

In seeking an inclusive and prioritised approach to improving the exchange of information, OECD surveyed member countries to identify what were regarded as the most common impediments to efficient exchange of information. The focus was on impediments to timely, secure, accurate and comprehensive exchange of information. The impediments identified cover the full range of issues facing administrations: policy, legal, organisational, systems, process, and people.

2. Policy

Policy issues included the need for some countries to improve the legal instruments for exchange of information by including the 2005 version of Article 26 in new and revised double taxation conventions and by negotiating tax information exchange agreements with offshore jurisdictions. In addition, some countries have advocated the introduction of specific time targets for responses to requests for information.

3. Legal

Several legal constraints have been reported. The first of these is the constraint of time limits on raising tax assessments which may be more difficult for the tax administration to meet when it is reliant on an exchange of information from a treaty partner. The second is the constraint of legal procedure that some countries impose on access to bank information e.g. the need to seek approval from a judge, a tribunal or similar before the bank can be required to hand over the information. It is possible that such requirements (aiming to protect the taxpayer's rights) are specified or managed in an overly restrictive manner.

4. Organisation

Organisational issues are centred on how exchange of information work is managed. At a practical level some tax administrations have established coordination roles to manage the interface between the exchange of information unit and the local tax staff. A growing number of countries is delegating competent authority to cross border regions). They have been able to report on the benefits achieved in terms of improved turn-round times.

5. IT Systems

IT systems to support exchange of information work can have a major positive impact. The issues here are not primarily technological but are concerned with providing good basic access to information systems and being able to effectively process and make use of data received from other countries. Efficiency can be impeded by the lack of access for the exchange of information team to the relevant IT systems that support the administration's tax databases. The absence of an IT system for effective and efficient distribution and use of bulk, automatic information received has also been reported as a perceived impediment. Up-to-date systems are of particular importance in the context of ensuring the confidential handling of taxpayer data during transmission and receipt.

6. Processes

It is recognised that differing and non standard procedures used within a tax administration can reduce the quality and add delay to the processing of requests. Failure to use Tax Identification Numbers has also been cited as an omission on requests received or information provided automatically . Several countries have identified the lack of feedback as a quality issue.

7. Human resources

There is a need to match staff resources to the increasing work levels. While there is not a direct relationship between the volumes of exchanges and the number of staff required (i.e. a doubling in the number of cases dealt with may not require a doubling of the staff allocated), some response is needed to ensure that exchange of information objectives including quality and effectiveness are met. Most exchange of information teams are quite small in relation to the size of their tax administration and so even a relatively small addition has the potential for a significant impact on results. More and more countries are including staff with tax audit experience in exchange of information teams.

8. Current work

OECD is carrying out further work looking in particular at some process issues. A working group is researching and developing a set of performance measures for exchange of information work which can be used for managing this work and improving the effectiveness of it. This work will also evaluate the proposal to introduce standard time limits for responses to requests. A further group is concerned with translation issues which are a common reason for delay and misunderstanding in processing requests for information. They are examining best practices which can be shared. The OECD is working with the European Union to build on the EU-led project on multilingual standardised electronic forms for exchange of information in order to have consistent standards OECD wide and even beyond.

9. Improving assistance in tax collection

The work on improving exchange of information is also largely relevant of assistance in tax collection but in addition specific work has just been undertaken on the practical aspects of collection assistance given that many countries are new to this form of co-operation. The aim is to share experiences and to address difficulties due to differences in domestic tax legislation.

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Information Exchange and Administrative Assistance for Recovery as Effective Mechanisms for Controlling Fraud, Evasion and Avoidance

“Transparency in Foreign Trade Transactions. Use of Countries which Lack Fiscal Transparency”

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Carlos Sánchez
(Argentina)

I. EXPORTS TRANSACTIONS THROUGH TAX HAVENS. DO THEY REPRESENT TRANSPARENT TRANSACTIONS?

I.1. Introduction

Along with the globalization of the economy, the exchange of goods, services and capital among countries as well as transactions in international markets increased significantly.

However, globalization has also brought about the behavior of certain private actors that perform transactions, which can be referred to as tax engineering, with the only purpose of getting tax benefits illegally. The most common practices aimed at reaching said goal are based on the artificial reduction of the tax base on which domestic taxes and export duties are levied, performing such transactions, through legal entities, domiciled or residing in countries with low or no taxation, as referred to in our laws, and known as tax havens, among other jurisdictions.

It is important to remember that tax havens are jurisdictions with low or no taxation as to the income of individuals or legal entities or with respect to certain economic activities. Also, the following requirements need to be met:

1. There exists bank, financial and/ or stock-market secrecy that can be claimed against tax authorities or other controlling entities or bodies.
2. There exist accounting and regulatory regimes for the establishment and operation of trading companies based on the imposition of minimum formal and material requirements.
3. There exist special systems that set forth benefits or fiscal advantages that are not granted to residents or tax privileges, or non- residents are granted advantages by the Fiscal Administration, at its own discretion.
4. There exists no effective fiscal information exchange.
5. There is no registered share recording regime.
6. There exists no compulsory filing of corporations in the pertinent registrars.
7. There are no corporate and/ or banking and financial comptrollership authorities.
8. There exists no tax withholding at source over dividends or interests paid to non- residents.
9. Residents are not required to be physically located in their territory and/or are not required to have business facilities where their businesses are managed, and/or their assets, risks and tasks are required to be according to the operations and businesses applied to them.

According to the experience of the Argentine Public Revenue Federal Administration [AFIP, in its Spanish acronym] in the control of international exports transactions, it was found that domestic companies have significantly reduced the income tax base and export duties in many cases when it was possible to identify the intended involvement of persons located in said jurisdictions that did not add economic value neither to the transacted goods nor to the business chain because of their lack of economic significance and real activity. This allowed for Argentine products to be exported at prices significantly lower than the prices at which they entered their destination countries, having been proved that in some cases the difference in US dollars is between 40% and 60%.

These differences in price caused a decrease in export duties and that the income subject to taxes in Argentina remained outside the country, specifically in tax havens where, in many cases, there is no taxation and which clearly has a negative effect on the Argentine tax collection and on the national productive effort.

I.2. Exports triangulation

The triangulation we refer to is the one that occurs whenever in the export business transaction one or more international intermediaries appear between the domestic exporter and the final receiver located, most of the times, in tax havens.

On the one hand, in this way, the transfer of title from one intermediary to another takes place through one or more international sales, the first one being the one from the domestic individual who will later report the export to customs. In spite of the subsequent international sales, goods do not leave the national territory.

Finally, the last individual to get an invoice –the final purchaser- is the one who takes on the capacity of final receiver and the one who will receive the goods that were subject to a real rebilling chain.

Whenever individuals who act between the local exporter and the effective receiver have not added any value neither to the product or to the marketing activity, there is no doubt that the purpose of the inclusion of these individuals within the transaction has the intention of undermining or avoiding the national tax base.

If we add the inner characteristics of the above mentioned tax havens to this situation, the immediate consequence is the lack of transparency that covers this type of exports making it impossible for the National Tax Agency to know whether the intermediaries have performed an activity that should be compensated so that it is possible to assign some profitability to the intermediary in the tax haven. That is why given these conditions, we can answer the question we posed in the title: These exports triangulation cases can in no way be regarded as transparent transactions.

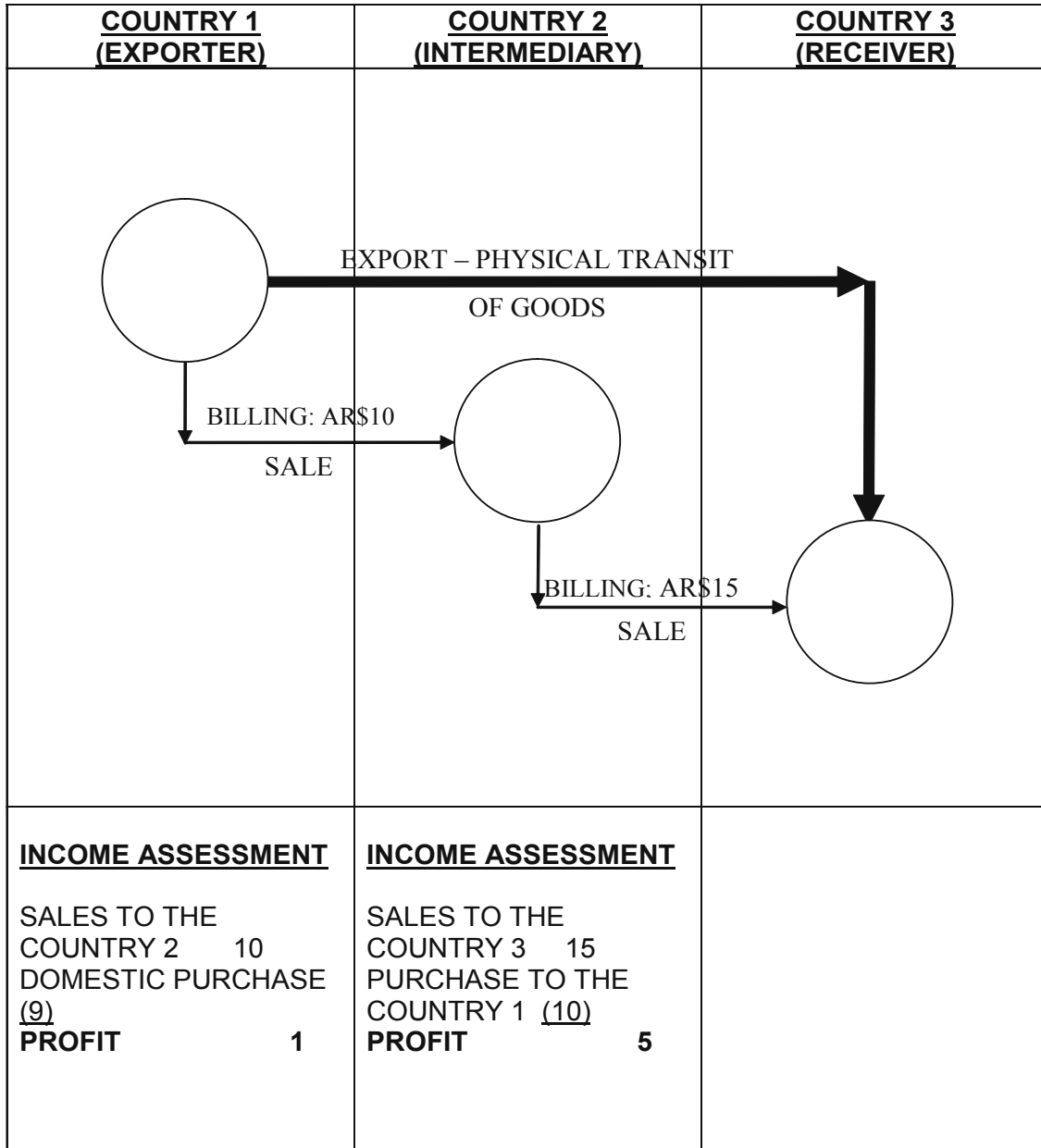
Moreover, that lack of transparency and the differences found by means of international information exchange between the export price and the import price –which are really significant in some cases- make clear that the aforementioned differences in price are not due to a compensation solely for the intermediation.

Collection of said exports through tax havens is as important as that and is also a cause for the lack of transparency, making evident the chance that some revenue generated by those export transactions remains hidden in those territories that do not support healthy fiscal competence.

We can now have a look at these graphic examples of the exports triangulations:

EXAMPLE GRAPHS OF EXPORTS TRIANGULATION

1. SIMPLE TRIANGULATION – ONLY ONE (1) INTERMEDIARY INVOLVED



BILLING ———
PHYSICAL TRANSIT OF GOODS ———

I.3. Measures adopted

The measures adopted as to tax havens are of diverse nature:

1. Legislative: Several amendments to the laws have made possible the introduction of a series of important measures aimed at discouraging the use of tax havens. Said measures will be mentioned later.
2. Among said measures, it is important to highlight the ones –regarding income tax- aimed at combating maneuvers to triangulate goods exports with known international prices through intermediaries with no economic substance, so that income is taxed based on the price of the good at the market on the shipping date. This price has been widely verified and is the price paid by the final receiver of the goods.
3. Tax and customs supervision: Important differences in favor of the Argentine tax administration were found by means of transfer prices and customs valuation procedures, as the performance of the international intermediary in the export triangulation was ignored because of its lack of economic substance and because it did not add value neither to the product nor to the business chain and, thus, it did not represent any income gained from its involvement in the business.
4. Controls: Both in terms of taxes and customs, the Argentine Public Revenue Federal Administration is devoted to the control and identification of taxpayers whose behavior is aimed at avoiding the national tax base by means of procedures such as the ones already mentioned.

To this purpose, a special control procedure is carried out to determine whether the export meets the necessary transparency requirements.

To this effect, the following will be regarded as irregular situations:

- The entrance of funds from a “Tax Haven” or a country that, because of its internal regulations, can claim bank, stock- exchange or any other type of secret at the request of information by the Federal Administration.
- The country of the final receiver of the goods and the country of the person billed do not match.
- The destination of the goods, the address that appears on the invoice, is a “tax haven” or a country that, because of its internal regulations, can claim bank, stock- exchange or any other type of secret at the request of information by the Federal Administration.
- The intervention of incorporated, domiciled or resident entities in “tax havens” is verified.

Given these situations, before the refund of exports VAT and drawback or refunds occur, companies will go through a valuation pre-approval process (taking into account the current times as to this issue). Once this has been pre-approved, the request is submitted and, should this not be possible, taxpayers will go through an examination process in order to determine whether tax damages have been caused in the triangulated transaction and, thus, procedural measures and those to determine the tax income that has not been collected will be adopted, if applicable.

By means of this procedure the Argentine Tax Administration is in line with the new and strong worldwide trends outlined by the G-20 as to the combat of the consequences that cause the damaging maneuvering of pernicious tax planning, when they involve persons located at these non- transparent jurisdictions, something being tried to be deactivated by most of the countries and different international organizations.

II. CURRENT SITUATION OF THE COMBAT OF TAX HAVENS BY INTERNATIONAL ORGANIZATIONS

As from the last G- 20 summit meeting, during which the country leaders stated that they would combat tax evasion in international operations, bilateral agreements for the exchange of information increased in number. International organizations are already working on the development of procedures that allow for the “effective” exchange of information, as well as the exchange of knowledge and experiences among the Tax Administrations that are part of it, aimed at early detection and efficient containment of tax evasion and avoidance.

II. 1. OECD¹ - Global Transparency and Information Exchange Forum

In October 2008 the Experts’ Committee of the United Nations for International Cooperation in Tax Affairs adopted the principles developed by OECD as to Transparency and Information Exchange in its own Taxes Agreement Model, thus setting forth the standards developed by OECD.

In April 2009, OECD issued a report on the progress of the implementation of the standards agreed internationally for the 84 jurisdictions² that are part of the Global Transparency and Information Exchange Forum of the OECD. According to said report, countries are divided into three different categories:

- Jurisdictions that have adopted the agreed standards: Argentina, Mexico, The Netherlands, Spain, USA, US Virgin Islands, Jersey and Isle of Man, among others.
- Jurisdictions that agreed to adopt said standards but have not yet implemented them: 33 jurisdictions are included in the list of tax havens of the OECD, as well as other financial centers, such as Austria, Chile, Luxemburg and Switzerland.
- Jurisdictions that have not agreed to adopt the standards: Uruguay, among them.

Later some of the countries mentioned in the last two categories have signed agreements for the exchange of information with the intention of being removed from the OECD lists.

As far as Uruguay is concerned, this country submitted a note to the OECD informing that it would formally adopt the transparency and tax information exchange standards, as set forth in section 26 of the OECD Taxes Agreement Model (2005 version) and that it is in the process to expand its set of international agreements, within which these standards would be incorporated. Moreover, it specifies that even though its regulations set forth bank secret restrictions, these agreements, once approved by the Congress, would outline a legal basis to reply to information requests, including information kept by the banks. In other words, these international agreements would be above the domestic legal restriction on access to information. Furthermore, it makes clear that some aspects in its current legislation, after the fiscal amendments established by Law 18,083 passed on December 26, 2006, are in accordance with the OECD international standards. The elimination of Financial Corporations (SAFI, in its Spanish acronym) as from the year 2011 was highlighted.

According to the OECD website as to the date of this presentation, after submitting said note, Uruguay would be excluded from the list of jurisdictions that have not agreed to adopt the internationally agreed standards, being one of the jurisdictions that have agreed to do so but have not yet adopted them.

Some of the results of the work being carried out by the Global Forum are the following:

¹ *Organisation for Economic Co-operation and Development.*

² *Those 84 jurisdictions are OECD member countries, tax havens identified in the year 2000 by OECD, countries that are part of the Tax Affairs Committee as observers (Argentina is one of them) and financial centers identified in the conclusions of the Global Forum which took place in Berlin in 2004.*

- All OECD countries have accepted section 26 of the OECD Taxes Agreement Model regarding information exchange. Moreover, Austria, Belgium, Luxemburg and Switzerland have withdrawn their reserves on said section.
- More than 40 information exchange agreements have been executed as of November 2008.
- Andorra, Liechtenstein and Monaco, identified by the OECD as non-cooperative tax havens, have approved the OECD standards and showed willingness to modify their domestic legislations and execute information exchange agreements. Moreover, Cayman Islands have passed laws that allow for information exchange and have identified 12 countries with which there exists willingness to execute said agreements.
- **All 84 countries revised by the Global Forum have accepted the implementation of the OECD standards.**

It is important to note that during the next meeting of the Global Forum in September, 2009, the report on results obtained during revisions carried out in the countries will be dealt with. As from 2006, the Global Forum has published annual assessments within an administrative and legal framework for the transparency and information exchange in the 84 countries mentioned above.

In the next two months, the CFA (Committee on Fiscal Affairs) and the Global Forum will address the following issues, among others:

- Strengthening the Transparency and Information Exchange Global Forum, by means of setting forth a peer revision procedure, monitoring the implementation of the agreed standards.
- Developing more measures against jurisdictions that do not cooperate and assess their efficiency.

II. 2. CIAT³

With regard to this, the AFIP undertook a significant international compromise during the Meeting of the Executive Council of the Inter-American Center of Tax Administrations (CIAT, in its Spanish acronym) held in Cancun, Mexico on March 30, 2003 by making a proposal as to the creation of a new workgroup aimed at dealing with issues related to damaging tax planning and its implications for the Tax Administrations.

This has remained like this since the AFIP became convinced of the importance international cooperation acquires in the control of international transactions and its implications, so as to develop cooperation areas that favor the control of tax liability due compliance involved in international tax issues and, thus, develop cooperation tools that allow for the protection of tax interests derived from it by each one of the competent Tax Administrations.

During the first stage of said workgroup, known as "International Tax Planning Control", whose leadership and promotion were carried out by AFIP and CIAT, a Manual was developed and submitted to all CIAT member Administrations during the General Assembly held in Barbados in May 2007.

Nowadays, said workgroup is still working, but its task during this new stage is aimed at better and more deeply addressing certain high impact issues as to damaging tax planning, by working hard on aspects such as the control of transactions agreed with persons located in tax havens, identification of new planning schemes and abuse of agreements to avoid double taxation (treaty shopping), among others.

Given the current significance of the issue, a database with cases from different countries is being developed by said workgroup, in which Argentina is in charge of its technical design together with CIAT and with the purpose of turning it into a receiver of said schemes and tools of abusive International Tax Planning so that it can be used by CIAT member Tax Administrations, not only as a guideline favoring

³ *Inter American Center of Tax Administrations.*

analysis for their own investigations, but also as a tool that makes it easier to share experiences and foresee tax damaging contingencies.

This type of abusive tax strategies, involving more than one tax jurisdiction, exceeds the limits to the national jurisdiction of each Tax Administration. This makes it clear that cooperation among national tax administrations is highly important in order to pursue control and punishment of damaging tax strategies used by taxpayers at the international level.

III. ARGENTINE ANTI- TAX HAVENS LEGISLATION AND INFORMATION SYSTEMS

III.1. Introduction.

For tax fraud, evasion and avoidance control purposes, our country has legal and regulatory provisions that allow for the efficient support of the tax administration testing capacity.

In that sense, it is important to mention that in order to identify countries with low or no taxation –tax havens- a list of countries that meet those criteria has been established in our legislation (Annex 1).

Furthermore, specific anti- tax haven provisions and a sanction system are foreseen, aimed at discouraging transactions of taxpayers with tax havens.

On the other hand, cross-border information exchange plays an important role for the Argentine tax administration, specially because of its strong decision of effectively controlling all aspects related to international transactions in order to protect all tax interests involved.

Another channel used by our tax administration in order to get international information for tax purposes from countries with which there are no agreements aimed at avoiding double taxation is the Argentine diplomatic service abroad.

Moreover, in order to strengthen control policies, the Argentine Federal Administration has established information regimes regarding all economic transactions, of whatever nature, even if they are at no expense, carried out by residents in the country and those who act as representatives of individuals or entities abroad and regarding all transactions involving the entrance of revenue from abroad by residents in the country, whenever they are originated from economic transactions.

III. 2. Tax Havens

The Argentine legislation refers to tax havens as “countries with low or no taxation.”

This includes, according to the income tax legislation, not only countries, but also domains, jurisdictions, territories, associated States or special tax systems.

During a first stage, our legislation referred to countries with low or no taxation –tax havens- using a definition set forth in a resolution issued by the Argentine tax administration in 1999 in order to identify them. Said resolution was later rendered ineffective.

This caused uncertainty among taxpayers who had to determine which were the territories that complied with the guidelines outlined in the referred definition in order to apply the provisions regarding these countries.

This is why during a second stage in November 2000, our legislation adopted the criteria followed by other countries and, therefore, listed all countries considered as countries with low or no taxation –tax havens-.

Thus, section 7 with no added number and following section 21 of the executive decree that put income tax in force now includes a list of **87 jurisdictions** with low or no taxation –tax- havens- detailed in Annex 1 attached hereto.

It is important to mention that there exists the possibility to exclude those countries, domains, jurisdictions, territories or associated States that set forth that an effective information exchange agreement executed with the Argentine Republic is in force or that stipulate amendments to income tax in their domestic legislation in order to adapt it to international standards that make them lose their status as jurisdictions with low or no taxation.

III.3. Summary of Anti- Tax Havens Regulations

Our legislation has adopted regulations whose purpose was to discourage the use of tax havens by taxpayers as part of certain damaging international tax planning schemes.

All these regulations are legal responses that are included in the income tax law, the executive order that put it effectively in force and other related regulations as well as in the tax proceedings law of our country. We can find the following regulations, among others:

Income Tax

Application of regulations and obligations as to transfer prices. These are not considered to be in accordance with regular market practices or prices among independent parties in transactions with tax havens⁴⁴. This implies that, whatever the type of transaction is and whether there exists a business relationship between the local operator and the tax haven person or not, the Argentine taxpayer shall apply the transfer prices regulations in order to justify that those transactions have been agreed at market value between independent parties.

In the case of **payment of interests to persons who are not residents of tax havens as listed, there applies an assumption of 100%** (instead of 43%) of revenue in order to assess the final withholding tax to foreign recipients (35%)⁵. It is important to take into account that this provision does not apply whenever the creditor is an Argentine financial institution.

Payment requirement for expenses and expenditures deductible with respect to tax havens. In general, our legislation establishes that in order to determine the taxable net income, companies' income and expenses shall be charged on an accrual basis. However, whenever it comes, for example, to payments that give origin to income of Argentine source for the person in a tax haven, these shall be charged on a cash basis⁶.

This implies that expenses shall only be deducted whenever income has been paid to the foreign recipient and, thus, withholding was made as a single and final payment over said profit.

⁴ Article 15, second paragraph of the Income Tax law.

⁵ Article 93, paragraph c) of the Income Tax law.

⁶ Article 18, last paragraph of the Income Tax law N° 20,628

This law is intended to avoid the charge of unpaid balances as expenses. That is why deduction is only allowed once income of Argentine source for the recipient of the country with low or no taxation –tax-haven- has been subject to taxation.

Application of the CFC rule (international tax transparency) for shareholders of companies located in tax havens⁷. This refers particularly to the allocation of income to stock companies located in tax havens.

With regards to this, it is outlined that income of the fiscal year for the permanent establishment is the income accrued during it and the establishment can charge it whenever it is due, if applicable.

Provisions as to income charge shall be applied correlatively for the charge of expenses, unless otherwise provided by law. As with regards to expenses that are not chargeable to a certain income source, these shall be deducted during the fiscal year when payment occurred.

These procedures apply to stock companies incorporated or located in tax havens with respect to income originated from interests, dividends, royalties, rent or any other similar non- operating income, as indicated by law.

Other related regulations:

Restrictions on the exemption on the purchase of shares of unlisted stock companies, for foreign offshore companies⁸, in which case it will be necessary to apply the final withholding to said companies as foreign recipients⁹. There is no reference made to the list of tax havens previously mentioned, but this definition is used in this case.

Exports of goods with quotation known in transparent markets (commodities), through an international intermediary: new method “International Price as of loading date”.

In 2003, changes were made to our tax law, to the executive order that makes it effective and other related provisions, in order to **discourage export transactions carried out by means of sham intermediaries, with no economic substance.**

This is why a new method for transfer price justification that reaches only export triangulations through sham intermediaries was introduced in order to correct improper acts that affect the income tax taxable base.

As it is clear, being said method aimed at reducing negative effects of a planning practice that is internationally regarded as damaging, its application does not affect the regular performance of regular or healthy business transactions. It does not discourage business transactions through “real” intermediaries.

It does not affect business practices or business contractual terms either. **In sum, it does not distort international trade among related individuals and does not reduce the competitiveness of the Argentine foreign trade, as the foreign purchaser pays the real price (which is higher than the one declared in the Argentine Republic).**

⁷ Article 133 paragraphs a) and b) of the Income Tax law.

⁸ These are those whose core of business, according to their legal nature or their bylaws, is to make investments outside the jurisdiction of the country where they were incorporated and/or can do certain transactions and/or make investments there that are expressly set in the applicable legal system or bylaws. There is no reference to the black list previously mentioned, but this definition is used in this case.

⁹ Article 20 paragraph w) second part of the Income Tax Law.

Finally, it is important to note that, according to the law, these situations can be proved otherwise.

Tax Procedure

Unjustified Net Worth Increase Assumption, unless otherwise proved by taxpayers in the case of entrance of income from tax havens¹⁰.

Said unjustified net worth increases of 10% in terms of income in cash or spent in non deductible expenses represent net income for the year during which they accrue at the time of determining income tax and the base to assess taxable activities omitted for said fiscal year in the value added and excise taxes.

This law is highly significant because in the event taxpayers do not fulfill the requirements set forth therein, income from countries with low or no taxation –tax havens- will not only be levied for income tax, but also for consumption taxes, which creates the assumption that they derive from omitted sales. In order to see the effect of these changes in our country more clearly, statistics are included as Annex 2.

III.4. Sanction System

As from 2003, sanctions were incorporated to the Argentine tax procedure law and are applicable to the breach of regulations related to international transactions.

The most important aspect of this reform was the increase in the penalties for the breach of formal and material obligations and, specially, breach related to international transactions. Thus, failure to promptly submit tax returns, failure to submit them whenever they are required, failure to give data at the request of the Argentine tax administration and failure to keep proof of transfer prices are particularly sanctioned. Moreover, degrees of penalties for omission of taxes originated from international transactions have been increased. The detail of the penalties for each type of breach are shown below:

Automatic Fines

- Failure to submit Tax Return for Import and Export Transactions among independent parties: Fines shall be of AR\$ 1,500 (about US\$400), which will be increased up to AR\$9,000 (about US\$2,360) in the case of companies incorporated in this country which are owned by foreign individuals or legal persons.
- Failure to submit Tax Returns in which transactions are specified, except for Import and Export transactions among independent parties: Fines total AR\$10,000 (around US\$2,630), which will be increased up to AR\$20,000 (around US\$5,260) in the case of companies incorporated in this country which are owned by foreign individuals or legal persons.

Fines for the failure to comply with Formal Obligations

The reform established the application of Fines that can reach AR\$45,000 (around US\$11,800) in the following cases:

- Failure to present data required by the Argentine tax administration for the control of international transactions.
- Failure to keep receipts and proof of prices agreed in the transactions.

¹⁰ Article 18.1 of the Tax Procedure Law N° 11,683.

Fines for Continuous Breach

- Fines for Continuous Formal Breaches: Fines can be up to AR\$45,000 (around US\$11,800). These are fines that can be added to the previously mentioned ones and can be adjusted according to the taxpayers' conditions and the seriousness of the breach.
- Fines assessed based on the Sales Revenue base: In the case of taxpayers whose annual income is AR\$10,000,000 or higher (around US\$2,625,000), in the event of failure to comply with the third requirement, applicable fines are two to ten times the established maximum amount of AR\$45,000 (equal to US\$11,800) and shall be added to the other fines.

Fines for Failure to Pay the Tax

Finally, the sanction system sets forth fines in the event of failure to pay this tax. As for international transactions, fines are equal to once up to four times the amount of the tax that was not paid or withheld.

III. 5. Information exchange

The Argentine Republic has signed 17 International Agreements to avoid double taxation in respect of those taxes levied on income and capital. Said agreements establish the information exchange mechanism, which has had good results in most of the cases.

During the last few years, this international cooperation mechanism has allowed countries to get information that is being used to check worldwide income, transfer prices and levying of international transactions, by means of the spontaneous or requested information exchange.

Moreover, our tax administration has a strong interest in promoting information exchange and it is important to note that our country has been a member of the CIAT working group that developed the Information Exchange Model.

In the Argentine Republic, legal sources upon which international information exchange is based are the following:

- The network of Agreements to avoid international double taxation and
- The tax procedure law that granted to the Argentine Public Revenue Federal Administration the power to lift the fiscal secret in order to execute international cooperation agreements.

Until the end of the year 1998 when changes, which regulate the worldwide income concept and incorporated the transfer prices system, were made to the income tax law, information exchange was not really significant and was limited to spontaneous and automatic information exchange by those countries that executed the Agreements and some sporadic cases of requested information exchange.

As from that moment, cross-border information exchange has played an important role in the Argentine tax administration, specially because of its strong decision of performing an effective control of all aspects related to international transactions in order to protect the fiscal interests involved.

In this context and after the Argentine tax administration was given these rights, Specific Information Exchange Agreements have been executed with the Tax Administrations of Spain, Brazil, Chile and Peru. The first three of them are ancillary to the Agreement to avoid double taxation and the last one refers to the rights of the Public Revenue Federal Administration and the lifting of the fiscal secret already mentioned.

All these specific Agreements were negotiated based on the CIAT Information Exchange Model, which includes the procedures to carry out simultaneous examinations. Currently, some other Agreements are being negotiated, even with the countries with which there is no agreement executed in order to avoid double taxation, also based on the CIAT Model.

The Argentine diplomatic service abroad is another mechanism used by the Argentine tax administration in order to obtain international information for tax purposes whenever there is no Agreement executed with the countries so as to avoid double taxation.

Cooperation has been very useful in many cases. Among those that can be highlighted, there is one in which the diplomatic service was able to validate the content of a website in which important evidence to ground the fiscal claim in the examination process of a taxpayer.

III.6. Information systems

It can be now mentioned that in order to solve the lack of information exchange in the control of transactions carried out with foreign persons and, specially, with tax havens, our Tax Administration has implemented different information systems, which are the following:

- **Information system for representatives of foreign persons and service suppliers.**

In 2002, the Argentine Tax Administration established an information system¹¹ in respect of all economic transactions of whatever nature, even if they are free of charge, carried out among residents in the country and those who act as agents of foreign individuals or entities. Informers are the agent as well as those who take part in said transactions as service suppliers, such as public notaries, banks, insurance companies, securities markets and currency exchange offices, among others.

- **Information system for the entrance of foreign income by residents in the country:**

During mid 2005, the Argentine Tax Administration considered it was necessary to pass a regulation¹² in order to establish an information system in respect of all transactions involving the entrance of foreign income by residents in the country and originated from certain business transactions whenever they are higher than US\$50,000 (or its equivalent in other currencies), per calendar month and per individual or legal person ordering such entrance, in all entities authorized to perform exchange transactions.

Information agents that, partly or fully, fail to submit information to this system, shall be subject to the sanctions under the Argentine procedure law with fines up to AR\$5,000 (US\$1,315), which shall be increased up to AR\$10,000 (US\$2,630) in the case of companies incorporated in the country which are owned by foreign individuals or legal entities.

- **Specific agreement for information exchange with the Central Bank of Argentina (BCRA, in its Spanish acronym).** The Tax Administration has signed this Agreement in order to strengthen the use of the public sector resources available.¹³

By means of this Agreement, the Central Bank of Argentina provides the Tax Administration with information about currency inflow and outflow overseas, identifying not only the local taxpayer but also their counterpart and the foreign country of residence.

¹¹ General Resolution (AFIP) N° 1375 (Official Gazette: 19/11/02)

¹² General Resolution (AFIP) N° 1926 (Official Gazette: 17/08/05)

¹³ Agreement executed on September 26, 2008.

This information helped to identify a significant amount of transactions performed with persons residing in tax havens and this allowed unpaid taxes examination and assessment actions.

- **Other policies:** In addition, it is important to note that, with the intention of implementing actions in order to strengthen supervision of securities transactions within the public offer, the Argentine National Securities and Exchange Commission placed some restrictions on said transactions whenever they are performed or ordered by individuals or entities incorporated, domiciled or residing in countries listed as tax havens pursuant to the income tax law.¹⁴

¹⁴ General Resolution N° 554/09 – Argentine National Securities and Exchange Commission (Official Gazette:14/05/09).

ANNEX I

LIST OF TAX HAVENS PURSUANT TO WHAT IS PROVIDED BY ARTICLE 7, WITH NO ADDED NUMBER FOLLOWING ARTICLE 21 OF THE EXECUTIVE ORDER MAKING REGULATING INCOME TAX LAW IN THE ARGENTINE REPUBLIC:

1. ANGUILLA (United Kingdom non autonomous overseas territory)
2. ANTIGUA AND BARBUDA (Independent state)
3. NETHERLANDS ANTILLES (Dutch territory)
4. ARUBA (Dutch territory)
5. ASCENCION
6. THE COMMONWEALTH OF THE BAHAMAS (independent state)
7. BARBADOS (independent state)
8. BELIZE (independent state)
9. BERMUDAS (United Kingdom non autonomous overseas territory)
10. BRUNEI DARUSSALAM (independent state)
11. CAMPIONE D'ITALIA
12. GIBRALTAR
13. THE COMMONWEALTH OF DOMINICA (Associated state)
14. UNITED ARAB EMIRATES (independent state)
15. STATE OF BAHREIN (independent state)
16. ASSOCIATED STATE OF GRANADA (independent state)
17. THE COMMONWEALTH OF PUERTO RICO (associated state of the US)
18. STATE OF KUWAIT (independent state)
19. STATE OF QATAR (independent state)
20. FEDERATION OF SAINT CHRISTOPHER AND NEVIS (Saint Kitts and Nevis Islands: Independent)
21. Regulation applicable to Holding companies (Law passed on July 31, 1929) of the Grand Duchy of Luxembourg.
22. GREENLAND
23. GUAM (United States non autonomous territory)
24. HONK KONG (Chinese territory)
25. THE AZORES ISLAND
26. CHANNEL ISLANDS (Guernesey, Jersey, Alderney, Great Stark Island, Herm, Little Sark, Brechou, Jethou Lihou)
27. CAYMAN ISLANDS (United Kingdom non autonomous territory)
28. CHRISTMAS ISLAND
29. COCOS OR KEELING ISLAND
30. COOK ISLANDS (New Zealand associated autonomous territory)
31. ISLE OF MAN (United Kingdom territory)
32. NORFOLK ISLAND

33. TURKS AND CAICOS ISLANDS (United Kingdom non autonomous territory)
34. PACIFIC ISLANDS
35. SOLOMON ISLANDS
36. SAINT PIERRE AND MIQUELON ISLAND
37. QESHM ISLAND
38. BRITISH VIRGIN ISLANDS (United Kingdom non autonomous territory)
39. UNITED STATES VIRGIN ISLANDS
40. KIRIBATI
41. LABUAN
42. MACAO
43. MADEIRA (Portuguese territory)
44. MONTserrat (United Kingdom non autonomous territory)
45. Item removed pursuant to Executive Order N° 115/02
46. NIUE
47. PATAU
48. PITCAIRN
49. FRENCH POLYNESIA (French overseas territory)
50. PRINCIPALITY OF ANDORRA
51. PRINCIPALITY OF LIECHTENSTEIN (independent state)
52. PRINCIPALITY OF MONACO
53. REGULATIONS APPLICABLE TO FINANCIAL CORPORATIONS (governed by Law No 11.073 passed on June 24, 1948 of the Oriental Republic of Uruguay)
54. KINGDOM OF TONGA (independent state)
55. HASHEMITE KINGDOM OF JORDAN
56. KINGDOM OF SWAZILAND (independent state)
57. REPUBLIC OF ALBANIA
58. REPUBLIC OF ANGOLA
59. REPUBLIC OF CAPE VERDE (independent state)
60. REPUBLIC OF CYPRUS (independent state)
61. REPUBLIC OF DJIBUTI (independent state)
62. CO- OPERATIVE REPUBLIC OF GUYANA (independent state)
63. REPUBLIC OF PANAMA (independent state)
64. REPUBLIC OF TRINIDAD AND TOBAGO
65. REPUBLIC OF LIBERIA (independent state)
66. REPUBLIC OF SEYCHELLES (independent state)
67. REPUBLIC OF MAURITIUS
68. TUNISIAN REPUBLIC
69. REPUBLIC OF MALDIVES (independent state)
70. REPUBLIC OF MARSHALL ISLANDS (independent state)

71. REPUBLIC OF DE NAURU (independent state)
72. DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA (independent state)
73. REPUBLIC OF VANUATU
74. REPUBLIC OF YEMEN
75. REPUBLIC OF MALTA (independent state)
76. SAINT HELEN
77. SANTA LUCIA
78. SAINT VICENT AND THE GRENADINES (independent state)
79. AMERICAN SAMOA (United States non autonomous territory)
80. INDEPENDENT STATE OF SAMOA (WESTERN SAMOA)
81. THE MOST SERENE REPUBLIC OF SAN MARINO (independent state)
82. SULTANATE OF OMAN
83. SVALBARD ARCHIPELAGO
84. TUVALU
85. TRISTAN DA CUNHA
86. TRIESTE (Italy)
87. TOKELAU
88. FREE ZONE OF OSTRAVA (a city in the Czech Republic)

ANNEX II

STATISTICS OF INTERNATIONAL TRANSACTIONS ACCORDING TO THE INTERNATIONAL TRANSACTIONS TAX RETURNS

Year	Total Exports reported in International Transactions Tax Returns US\$	Exports to countries with low or no taxation (PBNT, in its Spanish acronym) reported in International Transactions Tax Returns US\$	Relation Reported Exports to PBNT / Reported Total Exports PERCENTAGE
2003	17,154,602,554.52	2,719,090,078.98	15.85%
2004	19,343,438,707.88	1,372,827,326.36	7.10%
2005	20,892,232,943.80	1,332,530,117.71	6.38%
2006	23,153,745,388.01	1,586,694,902.25	6.85%
2007	27,520,415,603.01	1,810,718,176.81	6.58%
	108,064,435,197.22	8,821,860,602.11	8.16%

TOTAL EXPORTS OF THE COUNTRY (REPORTED BY THE GENERAL CUSTOMS DIRECTORATE) IN RELATION TO EXPORTS TO COUNTRIES WITH LOW OR NO TAXATION -PBNT- (REPORTED IN INTERNATIONAL TRANSACTIONS TAX RETURNS)

Year	Total Exports of the Country reported by the General Customs Directorate US\$	Exports to PBNT Reported in International Transactions Tax Returns US\$	Relation Reported Exports to PBNT / Reported in International Transactions Statements/ Total Country Exports PERCENTAGE
2003	28,913,956,603.23	2,719,090,078.98	9.40%
2004	34,236,044,325.20	1,372,827,326.36	4.01%
2005	39,474,385,014.91	1,332,530,117.71	3.38%
2006	46,188,536,195.25	1,586,694,902.25	3.44%
2007	55,256,993,127.88	1,810,718,176.81	3.28%
	204,069,915,266.47	8,821,860,602.11	4.32%