The Global Economic Crisis and Tax Administration

Presented at the seminar held by the Japan Tax Association and the IFA Japan Branch

October 30, 2009

International Monetary Fund
Fiscal Affairs Department

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This presentation is excerpts from

“Collecting Taxes During an Economic Crisis: Challenges and Policy Options”

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IMF Staff Position Paper

July 1, 2009 SPN/09/17

(http://www.imf.org/external/pubs/cat/longres.cfm?sk=23092.0)

Context

- Tax/GDP forecast to drop by 2% of GDP worldwide 2009–10
- Forecast assumes constant level of taxpayer compliance
- If compliance worsens, revenue will decline even more
- The crisis raises two key questions for tax administration:

(1) Will an economic downturn cause compliance to decline?

and

(2) How should tax agencies respond to the crisis?

Theoretical Literature on Tax Compliance

- Standard theories posit that tax evasion is:

  - negatively correlated with the probability of detection & penalty rate

  + positively correlated with income

- Therefore, theory suggests an economic downturn will improve compliance because taxpayers will take fewer risks as their incomes decline.
- However, It is plausible that a severe crisis could worsen compliance by creating conditions that are not accounted for by the standard theory

Factors Omitted from the Standard Theory

- Severe economic stress (bankruptcy) may encourage financially distressed businesses to engage in risky tax behavior to stay afloat
- Tight credit conditions may cause credit-constrained companies to use tax evasion as an alternative source of finance
- Shift in economic activity from formal sector (high compliance) to informal sector (low compliance)

Empirical Evidence on Tax Compliance

- US study shows individual income tax compliance is negatively correlated with the unemployment rate
- Study on China indicates that credit-constrained companies have higher rates of noncompliance
- Recent report by Schneider estimates “shadow” economy in OECD countries to increase by 0.5 percent of GDP in 2009

Preliminary Conclusions on Economic Downturn and Tax Compliance

- It is <u>probable</u> that an economic downturn will cause compliance to decline
- At a minimum, an economic crisis will shift the incidence of noncompliance across economic sectors and taxpayers
- Tax agencies need to be concerned about both of these outcomes

Tax Administration's two key objectives during an economic crisis

(1) Contain the expected decline in taxpayers' compliance

(2) Keep taxpayers in the tax system

Tax agencies need to develop a *tax compliance strategy* for the crisis

- expand assistance to distressed taxpayers
- refocus enforcement on highest revenue risks
- enact legislative reforms that facilitate administration
- improve communication with taxpayers

Expanding assistance to distressed taxpayers

Adjusting Advance Payments

Some advance payments may exacerbate taxpayers' cash flows

- adjust advance payments more closely approximate the taxpayer's final tax liabilities
- Indonesia and Chile: reduce monthly advance payment rate – <u>however</u>, must pay full tax at end of year

Accelerate the Issuance of Refunds

Tax refunds can provide vital cash flow relief to financially distressed taxpayers

- streamline processing refunds claims:
  - create special unit for processing refunds
  - simplify management approvals
- eliminate requirement for auditing all refund claims
  - low-risk claims post ▸ refund audit
  - moderate-risk claims ▸ pre-refund desk audits

Make greater use of payment options

- Liberalize installment arrangements for taxpayers with demonstrated financial hardship and good compliance histories
- Taxpayer must stay current in future tax liabilities; otherwise, installment plan is terminated and enforced collection initiated

Examples…

- **United States:** taxpayers are entitled to an installment arrangement *if they meet prescribed conditions*
  - installment does not depend on tax agency discretion
- **Singapore:** permits extended installment plans (with or without interest);
  - special unit in collection enforcement for installment arrangements

Refocus Enforcement on Highest Revenue Risks

Safeguard Revenue from Large Taxpayers

Ensure tight control over large taxpayers

- Expand number of taxpayers controlled by large taxpayer office and increase staff
- Shift focus of LT audit program to industries most impacted by crisis
- Increase use of audit specialists, including for financial products, valuation, and computer-assisted audit methods

Intensify Arrears Collection

- VAT and Payroll taxes present high risk to revenue collection
- Prioritization and speed of collection are crucial
- Close monitoring of large arrears cases to catch slippage early and stop the bleeding
- Providing tax agencies with a full set of legal powers to arrange payment extensions and to take severe enforcement action when needed

Giving greater attention to loss-reporting businesses

- Verify doubtful claims, particularly in cases of larger claims
- Ensure the legal requirements have been met for the losses to be carried forward, carried back, and transferred in a merger
- Check for possible abuses of tax losses by related companies

Enhancing the scrutiny of cross-border transactions

- Target more audits on international tax issues
- Increase disclosure requirements on international transactions
- Publish warnings on abusive international tax planning schemes
- Promote the exchange of information with the country’s anti-money-laundering agency

Contain the Cash Economy

- Identify high risk sectors and develop an understanding of taxpayer behavior
- Develop “partnerships” with industry and professional in high risk sectors
- Provide proactive and well-organized outreach efforts
- Deploy low cost methods for detecting noncompliance

Enact Legislative Reforms that Facilitate Administration

Opportunity to strengthen legal powers

- Enforcement powers
- Bankruptcy laws
- Access to banking information
- Allow tax agency to issue “private binding rulings”

Improve Communication with Taxpayers and Tax Officials

Approaches…

Adopt comprehensive communications strategy

- With taxpayers : inform taxpayers of implications of significant tax events
  - IRS website has posted "What If" scenarios for job loss, bankruptcy, etc.
- Within the tax agency : provide managers and staff with timely, accurate and specific guidance on how to apply the new rules
- With other stakeholders : establish and make better use of consultations with industry associations and tax professionals

The “What Ifs” Of An Economic Downturn

- The Internal Revenue Service recognizes that many people may be having difficult times financially. ..There are steps we can take to help ease the burden. You also should file a tax return even if you are unable to pay so you can avoid additional penalties. Here are some “What if” scenarios and the possible tax impact:

  What if I lose my job?
  What if my employer goes out of business?
  What if I close my own business?
  What if I sell my home for a loss?
  What if I file for bankruptcy protection?
  What if I can’t pay my taxes?
  What if I can’t pay my installment agreement?
  What if a levy on my wages is creating hardship?

Other examples…

- Ways of getting help
  - UK telephone contact center "business payment support service" arranges installment agreement via telephone
- Discourage noncompliance
  - Publicize results of specific compliance case and their consequences
- Industry Partnership
  - New Zealand: relationship-based approach on SME in selected cash economy industries

THE TAXATION OF FINANCIAL INSTITUTIONS AND INSTRUMENTS: CHALLENGES, ISSUES AND SOLUTIONS

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October 30, 2009

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International Tax Dialogue

Why so important?

- **The financial sector permeates economic activity**
  - Channels resources from those who save to those who invest
  - Facilitates payments for labor, goods and services
  - Allocates risk to those most capable of bearing it

Importance (cont…)

- **A healthy financial system underpins economic performance.**
  - Empirical evidence (World Bank) suggests efficient financial sector can contribute to higher growth
- **Recessions resulting from financial crises have profound effect on both growth and the fiscal position of countries**

Is taxation of the financial sector special?

- **Subject to same rules as non-finance activity**
- **.. but many “hard to tax” and problematic areas**
  - **Derivatives and complex financial instruments**
  - **Loan losses**
  - **VAT**
- **Very high mobility of tax base**
  - **Allocation of profits between affiliates; transfer pricing**

The financial sector is important for tax policy

- **Substantial revenue at stake**:
  - income tax on institutions directly and indirectly involved in financial intermediation
  - other taxes associated with capital income: withholding/commodity/transaction taxes.

…And tax administration

- **Financial sector vital for tax administration**
  - Withholding taxes on capital income but also channel for remittance of many taxes
  - Informational goldmine for revenue authorities

The problems

- Distorted tax system can lead to misallocation of resources
  - Strong incentives to transform labor into often lower taxed capital income (particularly in the services sector)
  - Channeling intermediation to lower taxed instruments

Problems (cont…)

- Financial income not subject to a single regime and often complex
  - Measurement of income is based on realisation (deferral)
  - Uncertainty of treatment : “ordinary” vs. “Capital gain”
  - Non-uniformity (dividends vs. interest)
  - Non-linearities (use of losses and their transfer)
- Arbitrage transactions aimed at transforming “high” into “low” taxed income

Key benchmark for policy: neutrality

- Tax system (for revenue collection purposes) should leave private decisions unaffected
- "Neutrality" important benchmark because of the fungibility of many financial arrangements (equivalence of differently labelled products and convergence of traditionally different financial market sectors)

Neutrality (cont…)

- Distributional and social concerns as well as the practicalities of administration need to be justified to deviate from “neutrality”

Globalization

- Globalization accentuates arbitrage opportunities which draw on tax differences
- How do we deal with the costs resulting (e.g. inefficiency, inequity and revenue loss) from international spillovers?

Globalization (cont…)

- What criteria should a country adopt to link its tax rules with those of other countries? Does the implementation of a “neutral” tax system need to be rethought in a globalized world?
- What lessons do the higher income countries have for developing countries in the area of sophisticated financial instruments?

Tax and market failure

- The financial system is permeated with "market failures" owing to imperfect information
  - creditor/debtor and manager/shareholder relationships
- Should neutrality be reconsidered in light of market failures? What types of deviations should be contemplated?

Market failure (cont…)

- Should the tax system be structured to correct for market failures?
- Make sure we do not inadvertently make matters worse

Administrative Challenges

- Radical changes in compliance of large business are currently underway through new administrative initiatives.
  - Greater awareness and understanding within revenue bodies of manner in which financial institutions work
  - Business-driven vs. tax-driven activity
- Importance of corporate (tax) governance

Administration (cont...)

- Significant progress on exchange of information following G-20 initiatives following taxpayer evasion and fraud cases
- What assessment can be given of these administrative initiatives to date?

Corporate Finance

- The corporate tax systems have a bias in favor of debt financing
- Dividing line between debt and equity is increasingly tenuous
- Should the distinction between debt and equity be eliminated?
  - How does globalization affect the debate

Corporate Finance (cont…)

- Can neutrality between debt and equity be achieved by other means?
  - Integration between corporate and personal income taxes?
  - Thin Capitalization rules
- Major reforms: Pro's and con's
  - Major reforms: ACE vs. CEBIT?

Innovative Financial Instruments

- Derivatives highlight many issues with current tax systems
  - Multiple ways of obtaining identical economic exposures but with vastly differing tax treatment
  - Difficulty in adapting new instruments to existing rules
- Increase the ease and scope for arbitrage

Innovative Instruments (cont…)

- What types of solutions? Pros and Cons
  - How should anti-avoidance be structured?
  - How should the tax administration be structured to cope with financial innovation?
- What is the scope for adopting international accounting standards ("Hedge accounting")?

Banks

- Are there lessons for taxation of banks arising from the crisis? What will be the impact of losses? On revenues? On the structuring of tax-driven transactions?
- Does the financial crisis change the manner in which provisioning for tax purposes is currently carried out? Should provisioning become pro-cyclical? Should provisioning be more closely aligned with regulatory and accounting rules?

Banks (cont…)

- Banks also play a major role in the tax system
  - Administration withholding
  - “Gate keeper” – source of information
- What lessons can be drawn from the trend towards a greater role for banks as withholding agents?

Insurance

- There has been increasing convergence between life insurance and other financial products. Yet, in most countries life insurance is subject to special tax treatment.
  - Exemption (partial or total) of premium payments
  - Income on reserves
  - Payouts and surrenders
- Is this special treatment justified?

Islamic Finance

- Do conventional tax rules need to be amended to allow for *sharia,* and if so how?
  - In the absence of special rules will the way *sharia* transactions are treated create distortions?
  - Existing treaty arrangements?
- Nature of a "level playing field" when "conventional" and Islamic financial transaction take place side by side?

Collective investment vehicles

- Taxed in various ways in different jurisdictions and by type of vehicle:
  - separate entity vs. pass-through
  - most countries aim to achieve neutrality between direct investments or through collective investment vehicles
- What factors determine this?
- How is neutrality achieved?
- How can the investment activities carried out by a vehicle be ring-fenced from other business activities?

Private equity and hedge funds

- Grown enormously in recent decades.
- Much of the activity is carried out offshore
- Organizational forms and arrangements in many jurisdictions influenced by tax
- Much of the income earned by the sponsors of the funds taxed as capital gains under current laws--should it be treated as labor income?

VAT

- The dominant treatment around the world is to exempt most financial intermediation and financial services
  - Under taxation of consumers; overtaxation of businesses
  - The extent and size of the distortions arising from the exemption of most financial services from VAT is unknown.
- How do the various proposed partial solutions stack up against each other?
- Has the time come for more radical solutions?

Financial Transactions Taxes

- Adopted by many countries for revenue purposes
- Numerous types—some very old (e.g., documentary stamp duties
- Sometimes suggested (e.g.Tobin Tax) as a means to reduce financial market volatility
- Yield significant revenue in short run and relatively easy to administer, but most evidence suggests revenue tails off over time
- May cause disintermediation and other distortions