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# Managing compliance risks of large businesses: A review of the underlying assumptions of co-operative compliance strategies

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## **Abstract**

Large businesses play a vital role in the economy e.g. as large employers and investors. They are also important for the development of countries and for economic growth due to their (tax) contributions to the state budget. With growing budget deficits, numerous accounting scandals and public outrage about aggressive tax planning, corporate tax non-compliance is more than ever a serious issue for countries worldwide. In the last decade many tax authorities have developed so-called co-operative compliance strategies as preventive instruments to influence corporate tax behaviour. We conclude that the most important assumptions underlying co-operative compliance strategies are the contributions to taxpayer compliance by improving perceived procedural justice, reducing taxpayer uncertainty and improving tax risk management by taxpayers. These assumptions can draw on some theoretical substantiation, but none of them can claim a solid grounding from empirical evidence.

This article is part of a PhD research project in which corporate behaviour with regard to tax compliance is the subject of research.

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## 1. INTRODUCTION

Traditionally, tax authorities used so-called *deterrence strategies* to address tax compliance risks. These strategies are based upon the assumption that the threat of detection and punishment enforces compliance. Such strategies have several disadvantages. Deterrence activities are for instance costly and difficult (Smith & Stalans, 1991). The ‘social costs’ can be even higher if taxpayers respond by increasing efforts to avoid detection and punishment. Deterrence models are generally based upon the assumption that all non-compliance is intentional, as a result of conscious decisions by taxpayers. Non-compliant behaviour, however, can also be unintentional. Such unintentional non-compliance is unlikely to be (significantly) affected by deterrence activities (Smith & Kinsey, 1987). Also, deterrence models only focus on individuals and their cost-benefit analysis, while taxpayers also might be concerned about their social reputation, justice and fairness (Wenzel, 2002). And finally, deterrence activities can encourage resistance amongst taxpayers due to heavy-handed treatment and perceived breaches of procedural justice (Job, Stout & Smith, 2007).

Deterrence strategies alone are unable to efficiently attain or maintain desired compliance levels (especially given a finite level of resources). Therefore, tax authorities also use so-called *advise and persuade* strategies in a sound *compliance risk management* (CRM) strategy.<sup>3</sup> Advise and persuade strategies seek to prevent harm rather than punish it. They focus on cooperation between regulator, enforcement authority and addressee rather than seeking confrontation, and make use of conciliation rather than coercion (Gunningham, 2010).

One type of advise and persuade strategy is called *co-operative compliance*. In the last decade many tax authorities have implemented co-operative compliance approaches, generally aimed at large businesses (OECD, 2013). Co-operative compliance can be seen as a preventive instrument to influence corporate tax behaviour and thus address specific tax compliance risks of (large) businesses. Although co-operative compliance currently seems to be very common in managing compliance risks of large businesses, there is still hardly any research about the underlying assumptions of these strategies and only very little evidence of their added value (OECD, 2013).

The exploration of co-operative compliance strategies is relevant for many reasons. Given the political and public attention of corporate tax non-compliance, (potential) effects of new strategies such as co-operative compliance strategies will be monitored closely. Society will require tax authorities to demonstrate how co-operative compliance strategies add value to the effectiveness of the tax system (OECD, 2013). Besides, corporate tax non-compliance—in contrast to individual tax non-compliance—and regulatory strategies combatting corporate non-compliance, have received scarce scholarly attention in the field of tax compliance.<sup>4</sup> This is surprising

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<sup>3</sup> CRM is a structured process for the systematic identification, assessment, ranking and treatment of tax compliance risks to stimulate compliance and prevent non-compliance based on the behaviour of taxpayers (OECD, 2004; EC, 2010).

<sup>4</sup> This is not entirely limited to *corporate* tax compliance. As noted by Richardson & Sawyer (2001, p. 249) the effect of contact with tax authorities on individual tax compliance has also received scarce attention in the time since Jackson & Milliron (1986). However, research in this area has increased since Richardson & Sawyer (e.g. Kastlunger, Kirchler, Mittone, & Pitters, 2009; Boylan, 2010).

given the economic importance of corporate taxes: in most countries the revenue of corporate taxes, such as corporate income tax, payroll taxes and value added tax, exceeds revenues from personal income tax.

Our study contributes to the literature by examining how co-operative compliance strategies are designed and how they are applied in practice. We distil the assumptions upon which co-operative compliance strategies seem to be based and discuss these assumptions within the context of (corporate) tax compliance research. The remainder of this paper is structured as follows. In section 2 we sketch the background for co-operative compliance strategies by discussing previous literature on corporate tax compliance. In section 3 we discuss the development of regulatory strategies and the origins of co-operative compliance. Subsequently, we provide an in-depth analysis of co-operative compliance strategies in section 4. Section 5 concludes this contribution.

## 2. FACTORS THAT INFLUENCE CORPORATE TAXPAYER BEHAVIOUR

Most literature on the subject of tax compliance is focused on the factors affecting *individual* tax compliance. It could be argued that individual and corporate tax compliance do not differ (much) since corporations, as fictitious entities, cannot decide to comply or not: their managers do (Joulfaian, 2000). These managers have, just like other individuals, their own attitude towards tax compliance and significantly affect *corporate* tax compliance by setting the ‘tone at the top’ with regard to the firm’s tax activities (Koester, Shevlin, & Wangerin, 2014) and by setting and evaluating tax strategies (Olsen & Stekelberg, 2014). However, an important difference between individuals and organisations is that organisations work (by definition) in groups, usually with several actors holding varying degrees of corporate responsibility (Ariel, 2011). Increasingly, the literature acknowledges this difference and focuses specifically on *corporate* tax compliance. In this section we give a brief and selected overview of the work that we consider to be relevant within the context of corporate tax compliance.

### 2.1 The economic approach of corporate tax compliance

The standard economic model of tax compliance assumes that taxpayers are driven by rational, cost-benefit driven decisions. Within this context, *tax rates* play an important part in the willingness of corporate taxpayers to be compliant. Simply put, an increase in the tax rate makes it more profitable to evade taxes and therefore taxpayers are more willing to be non-compliant (Downs & Stetson, 2014). For managers of corporations there is another potential gain in being non-compliant. Minimising the tax burden of a corporation is in the interest of shareholders and, as their representatives, the board of directors. Therefore, to align incentives, the *compensation of managers* responsible for taxes may depend (inversely) on effective tax rates achieved (Crocker & Slemrod, 2005). However, this might encourage tax managers to seek less legal ways to lower effective tax rates and thus lower corporate tax compliance (Philips, 2003; Armstrong, Blouin, & Larcker, 2012; Rego & Wilson, 2012; Powers, Robinson, & Stomberg, 2013).

The potential costs of non-compliance are determined by the (perceived) *detection probability* and the perceived level of *penalties*. From empirical research it can be

concluded that increasing probabilities of detection and the level of penalties can deter taxpayers from being non-compliant. However, the effects of deterrence factors are generally shown to be relatively small (e.g. DeBacker, Heim, & Tran, 2015). For corporations, *book-tax conformity* is an important aspect of the detection probability. Book-tax conformity refers to the degree to which accounting and tax regulations are aligned. A legal framework with high book-tax conformity reduces the extent to which firms can reduce taxable income while raising book income, because reporting book-tax differences in such a setting signals non-compliance. Therefore, a high degree of book-tax conformity increases corporate tax compliance (Mills, 1996, 1998; Hung Chan, Lin, & Mo, 2010; Lee & Swenson, 2012; Tang, 2014).

Whether a taxpayer is sufficiently tolerant of the risks involved is not only determined by the perceived risks, but also by the '*risk appetite*' (or the level of risk one is prepared to accept). Taxpayers can have different risk appetites (Skinner & Slemrod, 1985). The risk appetite of taxpayers often is an important factor in theoretical approaches to tax compliance. Small changes in risk appetite can have profound effects on the predicted level of compliance. No empirical studies regarding the effect of risk appetite on corporate tax compliance are known to us. Intuitively, one might expect risk appetite plays an important role in corporate tax compliance. Many (larger) corporations have a formal corporate strategy, including a formalised risk appetite; risk appetite is an important part of all enterprise risk management models (e.g. COSO, 2011).

An assumption underlying economic compliance models (such as Allingham & Sandmo, 1972) is that humans make rational decisions. A large section of scholarly literature on tax compliance questions this rationality in regard to tax decisions. The rationality of taxpayers is, for example, affected by the level of *uncertainty*. Uncertainty affects tax compliance due to the fact that, in practice, taxpayers are unlikely to have precise information regarding audit probabilities, audit effectiveness (detection uncertainty), the level of penalties and the correct interpretation of tax law (or, in total, their actual tax liability). Humans generally avoid ambiguity; therefore it is likely that this uncertainty will affect tax compliance behaviour (Casey & Scholz, 1991; Taylor & Richardson, 2013). Uncertainty has various effects on tax compliance. For example, uncertainty regarding the correct tax position can lead to unconscious non-compliance but also to a situation in which a taxpayer is taking the most favourable tax position and awaits a challenge from the tax authority.

*Complexity of the law* can also limit the rationality of taxpayers and affects tax compliance in multiple ways. For example, complexity may lead to a lack of knowledge by taxpayers. The law and regulations become simply too complex and/or too much to understand in their entirety. This may lead to (unintentional) non-compliance. Also, complexity may lead to an increase in the opportunity to be non-compliant and thus increase non-compliance (Agha & Haughton, 1996). Finally, complexity could also lead to a rise in compliance costs. This rise may in turn lead to a decline in compliance, especially when taxpayers decide whether to be compliant based upon a cost-benefit analysis (McKerchar, 2002; Eichfelder & Kegels, 2014). However, complexity of tax law, which for a long time (e.g. Vogel, 1974) has been thought to have a negative impact on tax compliance, seems very difficult to reduce (e.g. Cuccia & Carnes, 2001).

It is generally acknowledged that the standard economic model does not (fully) answer the question why people pay taxes. Tax compliance research shows that other—

psychological and sociological—considerations, such as norms, trust and fairness play an important role (Kirchler, 2007).

## 2.2 The role of norms, trust and fairness in corporate tax compliance

*Personal norms*, or a manager's own moral standards, are assumed to be an important determinant of corporate tax attitude (e.g. Law & Mills, 2014). Personal norms seem to affect tax compliance in multiple ways. They can, for example, add an extra deterrence effect of internal sanctions such as guilt or shame (Braithwaite, Murphy, & Reinhart, 2007). Personal norms also could make deterrence superfluous since taxpayers driven by these norms are motivated to comply irrespective of formal sanctions (Wenzel, 2007). If these taxpayers are audited, this could crowd out the intrinsic motivation of tax compliance (Gangl et al., 2013). Therefore, the experience of an audit (or a *prior audit*) might affect the willingness to comply. Recently there has been increasing scholarly attention for this predicted correlation between top management characteristics and corporate behaviour (e.g. Chyz, 2013; Olsen & Stekelberg, 2014; Chyz et al., 2014; Gaertner, 2014; Koester et al., 2014; Law & Mills, 2014). These studies consistently find that personal norms (i.e. top-management characteristics) have a significant influence on corporate tax behaviour.

Personal norms can be acquired through the internalization of *social norms* (Wenzel, 2004). Social norms can be seen as moral standards attributed to a reference group, for example, at the level of family and friends, occupation, ethnicity or country. Social norms affect tax compliance in a complex way and its influence can be relatively large (e.g. Bobek, Hageman, & Kelliher, 2013). Taxpayers generally overestimate the non-compliance of other taxpayers, which might negatively affect their own compliance (Wenzel, 2005). It might therefore be that social norms are an important factor explaining non-compliance behaviour. An important aspect of social norms for corporations are reputational concerns. Graham et al. (2014) found reputational concerns to be an important determinant of corporate tax planning.

The level of *trust* a taxpayer has in the government affects his willingness to pay taxes, as paying taxes can be seen as fulfilling an obligation towards the government. (Taylor, 2002). Legitimacy denotes, at the least, acceptance of the right of a government to rule and is an important aspect of trust in the government. The effect of legitimacy is an increased likelihood of compliance with governmental rules and regulations (Levi & Sacks, 2009). Legitimacy of the government is influenced by various factors, such as government activities (e.g. efficacy and efficiency of politicians) and political structure (e.g. direct versus indirect democracy). Empirical research shows a positive effect of trust in the government on corporate tax compliance (e.g. De Mello, 2009).

Regarding the tax system as a whole, *fairness* is the most important consideration for individual taxpayers (Kirchler, Hoelzl, & Wahl, 2008). Several fairness considerations have been found to be important factors affecting *individual* tax compliance. These are: 1) *distributive justice*, the feeling that society does not offer enough (tax funded) resources compared to the amount of taxes one must pay (Verboon & Van Dijke, 2007); 2) *horizontal equity*, the equal treatment of equally circumstanced taxpayers (Goetz, 1978); 3) *vertical equity*, the fairness of the relative tax burdens of different societal groups or strata (Wenzel, 2002); 4) *retributive justice*, the perception that the tax administration is fair in applying punishments when the rules are broken (Walsh, 2012); and 5) *procedural justice*, the perceived fairness of

the procedures involved in decision-making and the perceived treatment one receives from the decision-maker (Murphy, Tyler, & Curtis, 2009). Regarding corporate tax compliance, empirical research including equity considerations is extremely scarce.

Besides the above-discussed considerations, tax compliance research shows that in a corporate setting also specific corporate aspects, such as corporate governance, and other corporate characteristics could affect tax compliance.

### 2.3 The role of corporate (governance) characteristics

'*Corporate governance*' is a broad concept referring to the way corporations are directed and controlled (Jamali, Safieddine & Rabbath, 2008). Corporate governance characteristics can limit opportunities for managers to be non-compliant and increase the ability of a corporation to be compliant. For example, a greater proportion of non-executive directors on the board can lead to better monitoring of management, which increases corporate tax compliance (Lanis & Richardson, 2011; Taylor & Richardson, 2013; Richardson, Taylor & Lanis, 2013b).

The quality of internal control or *tax risk management* is also relevant in this context. Not all tax decisions, especially in complex organisations, are made by those who are (ultimately) responsible. Especially for VAT and payroll taxes, tax compliance can be dependent on internal procedures and collaboration between employees. In regard to these taxes, the strength of the so-called 'tax control framework' (which forms the basis of tax risk management) can affect corporate tax compliance, for example, in setting standard procedures and designing internal audits. However, empirical evidence of this role of tax control frameworks does not exist.

The use of *tax advisors* and *external auditors* can also be seen as corporate governance mechanisms. Tax advisors can have two opposing effects on tax compliance. They can help taxpayers exploit ambiguous features of the law, which contributes to greater non-compliance (Klepper & Nagin, 1989). Alternatively, they can contribute to compliance by enforcing unambiguous features of the law and by discouraging non-compliance through advising the taxpayer against reporting positions which are likely to be challenged by the tax authorities. External auditors also play a role in corporate tax compliance; higher audit quality is expected to positively affect corporate tax compliance. The presence of an external auditor functions as an extra control measure, which increases corporate tax compliance (Mahenthiran & Kasipillai, 2012). However, audit quality is, in turn, affected by the provision of tax advisory by an accounting firm (Habib, 2012).

*Corporate taxpayer characteristics* often do have an effect on tax compliance, but why this is so is rarely theorised (Eisenhauer, 2008). It seems likely that many taxpayer characteristics are an operationalisation of another determinant of tax compliance (e.g., in regard to individual tax compliance, age can be seen as an operationalisation of risk appetite).<sup>5</sup> *Profitability* and *ownership structure*, however, do seem to affect corporate tax compliance (McGuire, Omer & Wang, 2012; Badertscher, Katz & Rego, 2013). Regarding profitability, empirical research mainly finds a negative effect on corporate income tax compliance (Richardson, Taylor & Lanis, 2013a).

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<sup>5</sup> See Jackson & Milliron (1986) and Richardson & Sawyer (2001) for a discussion on different types of taxpayer characteristics and their effect on individual tax compliance.

Ownership structures can be quite diverse. Therefore, research regarding this subject is just as diverse and has focused on ownership characteristics such as foreign, hedge fund and family ownership. The effect of foreign ownership can be related to different social norms affecting the willingness to comply (DeBacker et al., 2013) but also to foreign owners not having full control of the firm's operations, which affects the ability to be compliant (Joulfaian, 2000). Hedge funds are generally found to be less compliant since they will, generally speaking, try to increase firm value in a relatively short term. Decreasing tax compliance might in this case be an effective strategy (Cheng, et al., 2012). Family firms seem to be more compliant since they have greater reputation concern with protecting the family reputation (Chen et al., 2010).

## 2.4 Factors influencing corporate tax compliance

In this section we discuss the factors influencing corporate tax compliance. Table 1 presents an oversight of all determinants of corporate tax compliance discussed in relation to corporations.

**Table 1: Factors influencing corporate tax compliance**

<b>Economic factors</b>	<b>Sociological &amp; Psychological factors</b>	<b>Corporate (governance) characteristics</b>
Tax rate	Personal norms	Board of directors composition
Manager compensation	Social norms	Tax risk management
Detection probability	Distributive justice	Tax advisors
Penalties	Horizontal equity	External auditors
Book-tax conformity	Vertical equity	Profitability
Risk appetite	Retributive justice	Ownership
Uncertainty	Procedural justice	
Complexity of the law	Trust	

It should be noted that there are many more factors, for example, relating to the economy or a culture of a country, that could influence the behaviour of taxpayers beyond the ones mentioned in this paper. These 'external' factors however are out of control for the tax authority. It should also be noted that not all factors have the same importance for corporate taxpayers and that they interact in influencing compliance behaviour amongst corporates.

## 3. EVOLUTION OF REGULATORY TAX STRATEGIES FOR LARGE BUSINESSES

Regulatory tax strategies for large business have changed significantly in recent years. Some insights from tax compliance literature, as discussed in the previous section, have found their way into the daily practices of tax authorities and influenced regulatory strategies (OECD, 2010a). Tax authorities for decades worked in the same way: they selected individual cases for auditing and handled these cases from a perspective of 'distrust'. These strategies are known as '*deterrence*' strategies. Within this context tax authorities and taxpayers often played 'hide and seek' in a tax

audit, for example, resulting in taxpayers disclosing no more information than strictly required according to the law. Tax audits are also time-consuming and not always effective, because they generally do not address the ‘causes’ of non-compliance and therefore do not ‘solve the problem’.

The limitations of a regulatory strategy solely based on deterrence slowly became obvious amongst tax authorities (OECD, 2002). The insights from tax compliance literature led to the notion of *compliance risk management strategies*, as advocated by the OECD (OECD, 2004) and EU (EC, 2010), in which tax authorities combine various elements of regulatory strategies to manage tax compliance risks. In the words of former US president Theodore Roosevelt, tax authorities started to speak softly besides carrying a big stick. For example, tax authorities started experimenting with regulatory activities aimed at taxpayers’ *willingness* to comply. These kind of regulatory activities were known as *advise and persuade* strategies. They were strategies that tried to improve voluntary compliance and were based upon cooperation.<sup>6</sup> Regulatory activities were to be based upon an understanding of compliance behaviour. Thus, rather than focusing on treating the symptoms of non-compliance, underlying determinants of non-compliance were addressed (OECD, 2004).

Simultaneously, important changes in the business environment occurred; rapid globalisation, internationalisation of businesses and a changing relationship between government and society (Van der Hel-Van Dijk & Van der Enden, 2011). The major stock market scandals involving companies including Enron, Worldcom, Ahold and Parmalat led to an increased focus on corporate governance (Committee Horizontal Monitoring Tax and Customs Administration, 2012). As a result, many countries introduced legislation and standards that now require large businesses to provide greater transparency, such as the Sarbanes-Oxley legislation in the US (OECD, 2013). The Netherlands saw the introduction of a corporate governance code known as the ‘Code Tabaksblat’ in 2004.

These developments, together with the increasing focus on advise and persuade strategies, led to the development of *co-operative compliance* strategies directed at large businesses. Co-operative compliance strategies are an example of an advise and persuade strategy (Gunningham, 2010). Several initiatives by individual tax authorities all directed at large businesses (OECD, 2007) have been implemented:

1. the American IRS initiated a *Compliance Assurance Process* (CAP) programme
2. the Netherlands Tax and Customs Administration (NTCA) initiated a *Horizontal Monitoring* (HM) programme
3. the Irish tax authorities initiated a *Co-operative Compliance* programme
4. the Australian Tax Office (ATO) initiated their *Forward Compliance Arrangement* (FCA)
5. Her Majesty's Revenue and Customs (HMRC) initiated the *Review of Links with Large Businesses* programme.

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<sup>6</sup> An important influence on the development of advise and persuade strategies was the publication of the book *Responsive Regulation: transcending the deregulation debate* by Ayres & Braithwaite in 1992.

In 2007 the OECD labelled these approaches ‘enhanced relationships’ (OECD, 2007). Five pillars were seen as being central to these enhanced relationships, namely understanding based on commercial awareness, impartiality, proportionality, openness through disclosure and transparency, and responsiveness by revenue bodies, and disclosure and transparency by taxpayers in their dealings with revenue bodies (OECD, 2013).<sup>7</sup> As a foundation to these five pillars, the enhanced relationship is based on establishing and sustaining mutual trust between taxpayers and revenue bodies (OECD, 2008a).

Over the next few years more countries started such ‘enhanced relationship’ programmes. Examples include Austria, Canada, Denmark, Finland, France, Japan, New Zealand, Russia, Singapore, South Africa, Spain and Sweden (OECD, 2013). Based on these developments, the OECD’s Forum on Tax Administration (FTA) prepared a new report in 2013 (OECD, 2013). One noticeable change in the 2013 report as compared to the 2007 and 2008a reports, is the use of the term *co-operative compliance*.<sup>8</sup> The motivation for this lies in the fact that the term enhanced relationships had connotations of inequality (possibly due to capture) in tax treatment (OECD, 2013). To prevent misunderstandings it was therefore decided to use the term co-operative compliance. This is in line with Scholz (1984) and the Irish co-operative compliance programme. While seemingly just a semantic discussion, the use of the term co-operative compliance reveals the underlying objective ‘as it not only describes the process of co-operation but also demonstrates its goal as part of the revenue body’s compliance risk management strategy: compliance leading to payment of the right amount of tax at the right time’ (OECD, 2013, p. 14).

Notwithstanding this renaming, the principal characteristics of co-operative compliance have remained the same. Of these characteristics, openness (through disclosure and transparency) is specifically mentioned by the FTA as being very important (OECD, 2013). Because of this, the OECD (2013) summarises co-operative compliance strategies as *transparency in exchange for certainty*.<sup>9</sup>

As another important change, the 2013 report stresses the importance of a tax control framework (TCF). The 2008a OECD report briefly mentions that corporations make use of a TCF, but does not elaborate on what that consists of. The 2013 report, however, stresses the importance of the TCF. As the 2013 report puts it: ‘Transparency in exchange for certainty cannot exist without disclosure of tax risks and the underlying [tax control] framework (...) provide assurance that these risks surface’ (OECD, 2013, p. 57).

Co-operative compliance strategies seem currently to be very common in managing the compliance risks of large businesses. A recent survey among 24 member countries of the large business network of the OECD shows all of these countries developed and/or implemented—formally or informally—a form of cooperative compliance (OECD, 2013). Although co-operative compliance seems ‘here to stay’ as part of regulatory tax strategies, it is a broad concept that varies not only over time but also across countries. Besides, there is no empirical evidence regarding the added value of these approaches (OECD, 2013).

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<sup>7</sup> See OECD (2007) for a discussion of these five pillars.

<sup>8</sup> Although the term co-operative compliance was also used in 2008 by the OECD (OECD, 2008b).

<sup>9</sup> Interestingly enough, this epitome does not (directly) mention the assumed objective of all tax authorities; maintaining and/or improving tax compliance.

## 4. AN ANALYSIS OF CO-OPERATIVE COMPLIANCE STRATEGIES

The OECD is a strong supporter of co-operative compliance as a strategy to improve corporate tax compliance. It has been a driving force behind the international development of co-operative compliance strategies (Colon & Swagerman, 2015). While co-operative compliance is a broad concept, OECD reports reflect the views and experiences of its member states and can be expected to represent the consensus on co-operative compliance thinking as it has actually been applied by tax authorities in the Western world.<sup>10</sup> In this section we identify the common denominators of these strategies, based on documentation from the OECD and from individual tax authorities.

### 4.1 Establishing a working relationship

Co-operative compliance strategies were introduced as ‘enhanced relationships’ (OECD, 2007). Ever since, building an effective working relationship with businesses has been a major objective of all co-operative compliance strategies.

There is a ‘basic relationship’ in any country between the tax authority and the taxpayer which is ‘characterised by the parties interacting solely by reference to what each is legally required to do without any urging or persuasion from the other’ (OECD, 2007, p. 1). As part of this basic relationship, many large business taxpayers focus on the legal requirements taking abusive or aggressive tax positions and awaiting a challenge from the tax authority (OECD, 2009a). This ‘cat-and-mouse game’ has resulted in long-running disputes, with high costs for both parties.

The enhanced relationship is meant as a move away from the basic relationship (OECD, 2007). Tax authorities try to establish a relationship with large business taxpayers based on trust and co-operation (OECD, 2013), in which both parties aim for an open dialogue instead of the cat-and-mouse game and look towards speedy resolution of issues instead of long-running tax disputes. Moving from a contentious relationship towards a relationship based on trust and co-operation is the starting point of all co-operative compliance strategies. For example, the goal of the Australian co-operative compliance strategy is ‘to build enhanced positive relations with large business’ (ANAO, 2014, p. 32). This is to be achieved through mutual respect and responsibility (Datt & Sawyer, 2011). As another example, the British co-operative compliance strategy is designed to promote a relationship based on trust and transparency (Freedman, Loomer & Vella, 2009). To enhance the relationship, there are several requirements of tax authorities and taxpayers.

### 4.2 Requirements of tax authorities

Mutual trust is key in improving the working relationship between tax authority and taxpayer. As the popular saying goes; trust is earned, not given. Trust can be established, but requires each party to behave in a way that is seen by the other parties as trustworthy (OECD, 2007, p. 15). To be perceived as being trustworthy, there are five requirements (‘key pillars’) regarding tax authorities. These key pillars are: commercial awareness, impartiality, proportionality, disclosure and transparency, and responsiveness (OECD, 2013). OECD member states that have initiated co-operative compliance programmes have found these pillars to be valid (OECD, 2013).

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<sup>10</sup> See also Verbeten & Speklé (2014) in relation to New Public Management.

Two pillars are perceived as particularly important: impartiality and proportionality (OECD, 2007; 2008a; 2009b; 2013). Impartiality requires tax authorities to demonstrate consistency and objectivity (OECD, 2013). Proportionality requires tax authorities to take taxpayer characteristics into account when pursuing or not pursuing a line of inquiry (OECD, 2007). Proportionality also requires tax authorities to discuss the implications of decisions before taking them and, in general, behave in a way that is human (OECD, 2007). Based on these two key pillars and their requirements of tax authorities, taxpayers have a reasonable expectation that revenue bodies will act consistently, objectively and fairly (OECD, 2008a).

The other three pillars—commercial awareness, disclosure and transparency, and responsiveness—can all be seen as contributing to tax authorities acting consistently, objectively and fairly. Commercial awareness requires tax authorities to have a good understanding of the commercial drivers behind the transactions and activities undertaken by large corporate taxpayers (OECD, 2013). For example, the Irish tax authorities name their approach based on a better understanding of the business as an important benefit for taxpayers from their co-operative compliance programme.<sup>11</sup> As a result, tax authorities should be able to respond more fairly to certain tax positions taken by taxpayers. Disclosure and transparency require openness about why the tax authority perceives particular behaviour or tax positions to be a risk, why the tax authority has asked particular questions or is seeking particular information (OECD, 2009b). Such openness will improve the (perceived) objectivity and fairness of the treatment a taxpayer receives. For example, the NTCA (2013) emphasises the importance of transparency and actively discloses its treatment strategy of large business taxpayers. Responsiveness requires tax authorities to establish a fair and efficient decision-making process (OECD, 2009b).

According to the OECD (2013), tax authorities should make the first move to improve the working relationship. By giving taxpayers consistent, objective and fair treatment, it is expected that taxpayers will reciprocate with improving their own behaviour. This assumption can be directly linked to procedural justice, one of the determinants of corporate tax compliance as discussed in section 2. The term ‘procedural justice’ is used to describe the perceived treatment a taxpayer receives from the tax authority and the perceived fairness of procedures involved in decision-making (OECD, 2004). Fairness, in this context, relates to relational aspects such as feelings and status as well as instrumental aspects such as monetary and time costs of the procedure (Stalans & Lind, 1997). An important component of co-operative compliance strategies in general, and horizontal monitoring more specifically, is the presumed positive effect on procedural justice. While scarcely studied in the context of tax compliance, there is some evidence of this effect from another field of compliance research. Nielsen & Parker (2009) found that co-operative behaviour by the regulator breeds an accommodating, co-operative attitude on the part of the regulated in the context of the Australian Consumer and Competition Commission.

### 4.3 Requirements of taxpayers

In building an enhanced relationship, taxpayers are required to provide disclosure and transparency (OECD, 2008a). The concepts of disclosure and transparency are related yet distinct from each other. Disclosure requires taxpayers to agree to go beyond

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<sup>11</sup> See: <http://www.revenue.ie/en/business/running/large-businesses.html#section2>, visited April 11, 2015.

compliance with their statutory reporting obligations and voluntarily report any information necessary for the tax authority to undertake a fully informed risk assessment (OECD, 2008a). This includes the disclosure of all issues that relate to tax positions that give rise to a possible material risk (OECD, 2007). It should also include any information necessary for tax authorities to make fully informed decisions regarding the tax position of taxpayers (OECD, 2008a). Transparency is the ongoing framework within which individual acts of disclosure take place (OECD, 2007). As such, transparency on part of taxpayers can be seen as an aspect of the required attitude of taxpayers within a co-operative compliance strategy.

Transparency as a required attitude of taxpayers is an explicit part of all co-operative compliance programmes. For example, the Irish tax authority requires commitment by business to being open as part of its co-operative compliance programme.<sup>12</sup> As another example, the American tax authority states that taxpayers should provide information and documentation proactively as part of its CAP programme.<sup>13</sup> Also, the British tax authority expects a taxpayer participating in its co-operative compliance programme to raise significant compliance issues, uncertainties and/or irregularities with HMRC in real time.<sup>14</sup> Finally, within the Dutch HM programme taxpayers are required to be transparent about their tax strategy and relevant tax issues (NTCA, 2013).

Adequate transparency and disclosure is dependent on a robust system of internal control (OECD, 2013). In other words, to be able to be fully transparent regarding tax risks it is necessary for a taxpayer to be in control regarding these risks. A Tax Control Framework (TCF) is the part of the internal control system that assures accuracy, timeliness and completeness of tax returns and disclosures made by a corporation. As a result, the improvement of tax control is an important condition of all co-operative compliance strategies. For some co-operative compliance strategies this improvement is promoted by having a good TCF (*'the taxpayer has good internal controls'*) as a condition for participating in the programme (e.g. the US CAP).<sup>15</sup> For others, this improvement of the TCF is part of a co-operative compliance strategy in the form of an on-going process (e.g. the Dutch HM programme).

#### 4.4 The aims of co-operative compliance strategies: taxpayers

For taxpayers, the enhanced relationship is a means having tax matters resolved quickly, quietly, fairly and with finality (OECD, 2007). Large taxpayers view the increase of certainty as one of the most important advantages of co-operative compliance (OECD, 2007; 2009b). Tax authorities can increase taxpayer certainty regarding their tax position by increasing taxpayer knowledge of the authorities' position on tax issues and by increasing taxpayer knowledge of the authorities' audit plan (OECD, 2009b).

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<sup>12</sup> See: <http://www.revenue.ie/en/business/running/large-businesses.html#section10>, visited March 9, 2015.

<sup>13</sup> See: [http://www.irs.gov/irm/part4/irm\\_04-051-008.html](http://www.irs.gov/irm/part4/irm_04-051-008.html), visited March 9, 2015.

<sup>14</sup> See: <http://www.hmrc.gov.uk/manuals/tcrmanual/TCRM1000.htm>, visited March 8, 2015.

<sup>15</sup> See: [http://www.irs.gov/irm/part4/irm\\_04-051-008.html#d0e281](http://www.irs.gov/irm/part4/irm_04-051-008.html#d0e281), visited April 11, 2015.

#### 4.4.1 Interpretation of tax issues

Taxpayers might see potential for a significant difference of interpretation between them and the tax authority regarding certain tax issues (OECD, 2010b). If a taxpayer does not disclose uncertain tax positions, it is more difficult for the authorities to determine whether a transaction is potentially subject to dispute, due to the fact that they are less informed (Datt & Sawyer, 2011). A potential difference of opinion however, also could lead to uncertainty regarding tax issues for the taxpayer himself. As part of their co-operative compliance strategy, tax authorities provide taxpayers with the opportunity to gain certainty regarding specific tax issues (Datt & Sawyer, 2011). For example, the British tax authority 'will give binding rulings across all relevant taxes to businesses that provide clear plans for significant investment or corporate reconstruction; or a binding view of the tax consequences of significant commercial issues, pre or post-transaction, where there is legal uncertainty' (HMRC, 2007, p. 17). As another example, the Canadian tax authority provides 'a written statement (...) stating how [they] will interpret and apply specific provisions of existing Canadian income tax law to a definite transaction or transactions which the taxpayer is contemplating' (OECD, 2009b, p. 28).

#### 4.4.2 The audit plan

Taxpayers face uncertainty regarding whether they have identified all 'tax issues'.<sup>16</sup> By performing an audit, a tax authority might detect transactions that were not identified by a taxpayer as a relevant tax issue while the tax authority might have a different opinion. Uncertainty might derive from a misjudgement of what the tax authority might define as a tax issue, a failure of the TCF in detecting all tax issues and/or unpredictable behaviour on part of the tax authority. Tax authorities can increase taxpayer certainty by sharing their audit plan.

As an example, the Irish tax authority states that audits will 'be signalled to the business as part of each year's overall risk management plan'.<sup>17</sup> As another example, for each taxpayer within the large business division, the NTCA draws up a so-called strategic supervision plan. This plan contains the selection of regulatory activities and the planning of these activities (NTCA, 2013). To increase predictability of its regulatory activities, the NTCA shares this supervision plan with taxpayers within horizontal monitoring after a compliance agreement has been concluded (NTCA, 2013). Through sharing the supervision plan, the NTCA aims at increasing taxpayer certainty (NTCA, 2013).

Tax authorities can also improve taxpayer certainty by providing information on tax issues and the audit plan at an earlier moment in time. As a result, and as part of their co-operative compliance strategy, tax authorities try to move from an examination of tax returns after filing to a real-time evaluation of risks and compliance issues to improve taxpayer certainty (OECD, 2009b). For example, taxpayers participating in the CAP programme of the American tax authority are able to achieve tax certainty sooner.<sup>18</sup> The OECD (2009b) describes several methods and programmes of

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<sup>16</sup> Given the presumption that taxpayers aim for full disclosure and transparency. If not, this type of uncertainty might also relate to deliberately withheld tax issues.

<sup>17</sup> See: <http://www.revenue.ie/en/business/running/large-businesses.html#section7> , visited December 31, 2014.

<sup>18</sup> [http://www.irs.gov/irm/part4/irm\\_04-051-008.html](http://www.irs.gov/irm/part4/irm_04-051-008.html) , visited March 8, 2015.

participating countries in order to provide certainty to large taxpayers and address compliance on a real-time basis, such as forward compliance arrangements, advance rulings and advance pricing agreements.

According to the OECD (2009b) an increase of certainty is, in practice, indeed achieved through co-operative compliance strategies. For example, from the evaluation of the first pilot with 20 very large businesses it was concluded that HM did indeed lead to an increase of certainty (OECD, 2013). Also, Beck & Lisowsky (2014) found that the American CAP programme—a form of co-operative compliance—led to a significant reduction of taxpayer uncertainty.

Increasing certainty is the most important benefit for taxpayers of co-operative compliance strategies (Ventry, 2008). However, to receive this certainty from tax authorities, taxpayers need to be transparent and disclose all issues that relate to tax positions that give rise to a possible material risk. (OECD, 2007). Without this information tax authorities are unable to provide certainty. From the perspective of the taxpayer a co-operative compliance relationship can therefore be seen as a kind of transaction, in which transparency is exchanged for certainty.

#### **4.5 The aims of co-operative compliance strategies: tax authorities**

From the perspective of tax authorities, improving the working relationship with taxpayers is not an end in itself but a means of establishing the right amount of tax payable by taxpayers in a quick, fair and efficient manner (OECD, 2007). In other words, by implementing a co-operative compliance strategy tax authorities aim to influence and promote large taxpayer compliance (OECD, 2009b). For example, the Irish co-operative compliance programme is designed to provide greater levels of taxpayer compliance (OECD, 2007). As another example, the United States Government Accountability Office reports that anecdotal evidence indicates that the American CAP programme is effective in ensuring compliance (United States Government Accountability Office, 2013). The New Zealand tax authority also stated that encouraging large taxpayer compliance was the goal of their co-operative compliance pilot.<sup>19</sup> Based on early experiences of eight OECD member states, the OECD (2009b, p. 26) concluded:

Building a new form of relationship with large business is one of the key strategies adopted by the participating countries to influence and promote large taxpayer compliance.

How a co-operative compliance strategy should contribute to increasing taxpayer compliance is seldom explicitly stated. However, the OECD provides some insight into how taxpayer compliance can be increased. Taxpayers who believe they have been, or will be, dealt with fairly by the tax authority are much more likely to comply with its requirements than those who believe the system is not fair (OECD, 2000; 2010b). In the words of the OECD (2014, p. 77): ‘compliance, and by extension revenue, flows from taxpayers’ belief in the willingness (trust) and ability (confidence) of the revenue body to conduct its business fairly and objectively’. Empirical evidence for this expectation is scarce, although some evidence can be found in other fields of compliance research. Regarding subsidiary top management

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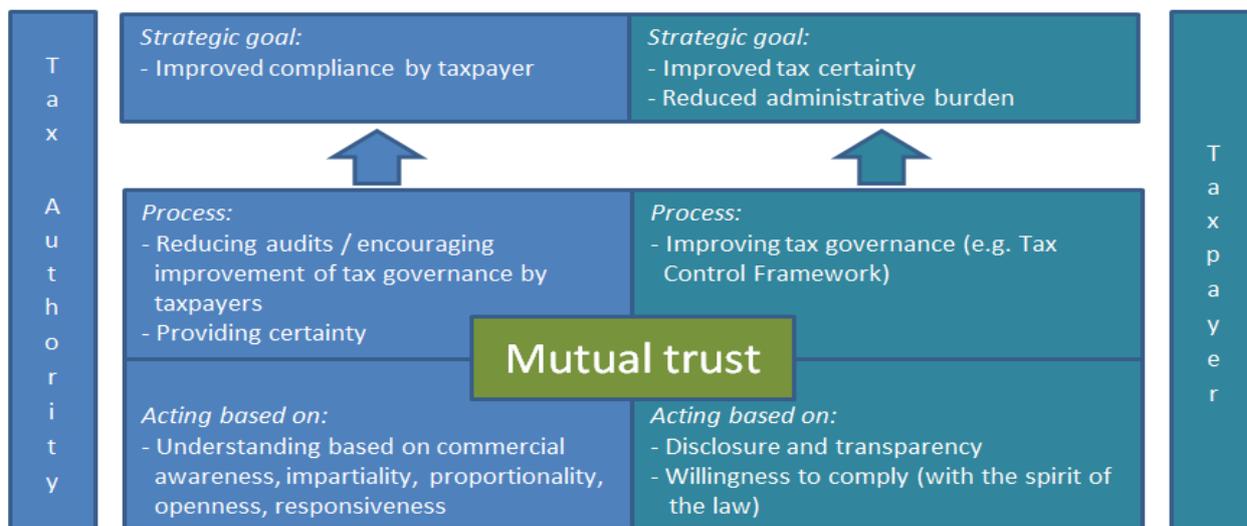
<sup>19</sup> <http://www.ird.govt.nz/aboutir/reports/compliance-focus/compliance-focus-2011-12/confidence-certainty/focus-confidence-certainty.html>, visited March 8, 2015.

compliance with multinational's corporate decisions, Kim & Mauborgne (1993) found a positive effect of procedural justice. Also, Makkai & Braithwaite (1996) and Braithwaite et al. (1994) found a positive effect of procedural justice on nursing home compliance. In regard to the presumed effect of an increase in procedural justice on corporate tax compliance, the OECD (2009b, p. 26) concluded, based on a survey amongst eight member states: 'improving and building a relationship based on transparency, trust, and mutual understanding would have a positive impact on large business compliance.' Also, a survey study by the Inland Revenue Authority of Singapore (IRAS) found that perceptions of fairness of the IRAS among taxpayers were directly related to tax compliance (OECD, 2010a).

#### 4.6 The common denominators of co-operative compliance strategies

From the above, the common denominators of co-operative compliance strategies can be distilled. In Figure 1 we divide the common denominators of corporate compliance strategies into strategic goals, the actual process and the basic requirements in the area of behaviour for both the tax authority (left) and the taxpayer (right). In other words, we distinguish between *how* both parties should act, *what* they should do and *why* they do it. Establishing and sustaining mutual trust between taxpayers and revenue bodies is pictured centrally, since this is the foundation for the relationship between both parties.

**Figure 1: The common denominators of co-operative compliance strategies (as compiled by the authors)**



### 5. CONCLUSIONS AND DISCUSSION

Many countries currently are suffering from large budget deficits and are—at the same time—confronted with large revenue losses due to tax non-compliance (the so-called ‘tax gap’). Auditing large businesses in a traditional way is not sufficient anymore to deal effectively and efficiently with compliance risks of large businesses. Since the beginning of this century tax authorities have been exploring the possibilities of overarching compliance risk management (CRM) strategies, in which elements of several regulatory strategies—such as co-operative compliance and deterrence

strategies—are combined. Within CRM, the application of the right type of approach for a certain taxpayer and at a certain time depends on an analysis of the taxpayer's behaviour. An improved understanding of taxpayer behaviour can therefore help tax authorities to make better decisions managing compliance risks of e.g. large businesses.

Before we discuss our conclusions further, a few caveats are necessarily in order. First, in this article we present an overview of the common denominators of co-operative compliance programmes, mainly based on OECD literature. In practice, there are many different applications of 'co-operative compliance thinking' that—in various degrees—differ from what we describe in this article. However, it must be noted that all applications do indeed share some basic principles, such as the willingness of most large business taxpayers to comply. Also, where possible, we supplemented our reasoning based on the OECD reports with examples from specific co-operative compliance strategies from individual countries. Second, there is a striking lack of empirical evidence regarding corporate tax compliance in general and co-operative compliance strategies specifically. All conclusions relating to co-operative compliance strategies are therefore tentative at best. It must be noted though that several OECD reports do provide some anecdotal evidence.

Co-operative compliance envisages an enhanced relationship between tax authorities and taxpayers (usually large businesses) in which both parties cooperate to effectively and efficiently maintain or improve tax compliance. To be able to measure the effects of corporate compliance strategies, one must understand the 'inner workings' of such regulatory instruments. In other words, the assumptions underlying these instruments must be made explicit. In this article we analysed co-operative compliance strategies and discussed the assumptions as they can be derived from several OECD reports and documentation of individual countries. These strategies and assumptions can be viewed from both the perspective of the tax authorities or the taxpayer.

Tax authorities are required to give taxpayers a consistent, objective and fair treatment. It is assumed that such a treatment increases taxpayer compliance. We link this to an improvement in perceived procedural justice. However, while there is substantive empirical evidence of a positive effect of procedural justice on individual tax compliance, there is no such evidence with regard to large business taxpayers. More broadly speaking, there is a lack of evidence regarding the effect of so-called advise and persuade strategies on compliance (Shapiro & Rabinowitz, 1997; Krawiec, 2003). Also, advise and persuade strategies are vulnerable to strategic behaviour of those not wanting to comply voluntarily (Voermans, 2013). However, though lacking empirical evidence, an econometric model developed by DeSimone, Sansing & Seidman (2013) shows that co-operative compliance strategies can be mutually beneficial.<sup>20</sup>

Within a co-operative compliance programme, taxpayers are required to provide disclosure and transparency. It is assumed that this will increase taxpayer certainty, since disclosure and transparency enable tax authorities to provide this certainty. The wish or need for certainty of taxpayers and the ability of tax authorities to provide certainty are therefore important prerequisites of a co-operative compliance strategy.

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<sup>20</sup> There is some empirical evidence from other fields than tax compliance for the effectiveness of a cooperative compliance strategy, e.g. Earnhart & Glicksman (2015).

Tax risk management plays an important role within co-operative compliance strategies. It is assumed that improving the so-called tax control framework (TCF) can both enable taxpayers to disclose all relevant information on tax risks and increase actual compliance. The assumption that improving internal control frameworks, like a TCF, can improve compliance behaviour is, however, disputed. For example, Power (2009) argues that risk management frameworks might be more about creating organisational accountability than about actually managing risks. Thus, implementing and improving a TCF might just be a form of 'cosmetic compliance' (Krawiec, 2003). While both sides whether a TCF can be beneficial to compliance can be argued, it should be emphasised that empirical substantiation for both sides of the argument is lacking (Huisman & Beukelman, 2007).

We conclude that the most important assumptions underlying co-operative compliance strategies are the contributions to taxpayer compliance by improving *perceived procedural justice*, reducing *taxpayer uncertainty* and improving *tax risk management* by taxpayers. These assumptions can draw on some theoretical substantiation, but none of them can claim a solid grounding from empirical evidence. This emphasises the need for both effect measurement by tax authorities and scholarly (empirical) research. This lack of empirical, scholarly research seems to be an overarching characteristic of advise and persuade strategies. Further research should, therefore, focus on finding ways to empirically testing the assumptions of advise and persuade strategies in general and co-operative compliance strategies more specifically.

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