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Collecting Taxes During an Economic Crisis: Challenges and Policy Options

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**Collecting Taxes During an Economic Crisis:
Challenges and Policy Options**

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EXECUTIVE SUMMARY

The global financial and economic crisis presents major challenges for tax administration. With the economic downturn, tax agencies are encountering growing compliance risks and greater demands for taxpayer support in the face of prospective budget cuts. This paper examines these challenges and sets out a strategy and measures for responding to them.

Theoretical and empirical studies suggest that an economic downturn tends to worsen taxpayer compliance in important aspects. While a drop in compliance may have some countercyclical effects on the economy, tolerating noncompliance is not an appropriate response to the crisis because it is distortionary, inequitable, and, perhaps most importantly, hampers the rebuilding of tax bases over the medium-term.

In responding to the crisis, the paper encourages tax agencies to develop a tax compliance strategy that is structured around two objectives: containing the growth in noncompliance and helping taxpayers to cope with the crisis. To achieve these objectives, four sets of measures are identified: (1) expanding assistance to taxpayers, (2) refocusing enforcement on the highest revenue risks, (3) introducing legislative reforms that facilitate administration, and (4) improving communication and outreach programs. Some measures—such as tax amnesties and moratoria on audits—are counterproductive and should be avoided.

In implementing the proposed strategy, countries should keep in mind a number of key points. First, early warning of emerging compliance risks is crucial for their mitigation. Second, a high-level group needs to be established within the tax agency to coordinate the development of the crisis strategy. Third, government support for tax administration is more important than ever during a crisis. Finally, tax agencies should align their near-term compliance strategies and medium-term modernizations plans.

I. INTRODUCTION

1. **The current global financial and economic crisis presents major challenges to revenue administration in many countries.**² With worsening economic conditions, tax agencies around the world face growing compliance risks involving such issues as tax arrears, loss-reporting businesses, tax withholding, and the cash economy. At the same time, agencies are being asked to provide taxpayers with additional support and assistance to help them cope with their obligations. And complicating their response to the crisis, some tax agencies face prospective budget cuts as governments wrestle with increasing fiscal pressures.

2. **In this context, this paper examines the emerging challenges to tax collection and the measures for addressing them.** The rest of the paper is structured as follows: Section II assesses the implications of the economic crisis for tax administration and lays out a general strategy for tax agencies to respond to the crisis. Sections III-VI provide examples of measures to underpin the strategy, drawing on the experience from several leading tax agencies and the work of the IMF. Finally, Section VII highlights emerging compliance risks in the financial sector, which has come under severe economic stress in several countries.

II. THE ECONOMIC CRISIS AND ITS IMPLICATIONS FOR TAX ADMINISTRATION

3. **The global economic crisis has led to a substantial decline in government revenue relative to gross domestic product (GDP) in many countries, which seems likely to continue for some time.** For many countries, the revenue decline began in 2008 when general government revenue dropped by an average of 0.8 percentage point of GDP worldwide.³ This decline appears to have accelerated in 2009: the annualized tax yield decline averaged 4 percentage points of GDP across selected emerging and developing economies in the first quarter of 2009.⁴

4. **Many different, but interrelated, factors could cause revenue to decline in relation to GDP.** Three particularly salient factors are (1) the tendency of some tax bases to decline faster than GDP in the face of an economic downturn,⁵ (2) a decline in commodity prices and related revenues, and (3) discretionary changes in tax policy. A fourth factor that

² The overall fiscal implications of the crisis are described in IMF (2009a). Crisis-related issues in tax policy are set out in IMF (2009b).

³ Source: IMF (2009c).

⁴ Staff estimates based on 16 emerging and developing economies, for which revenue data were available for the first quarter of 2009.

⁵ Profits, capital gains, excises, and imports tend to decline faster than GDP during a recession.

may significantly affect revenue performance in a crisis, however, has received less attention: the possibility of changes in taxpayer compliance, which is the central focus of this paper.

A. The impact of an economic downturn on taxpayer compliance

5. **Noncompliance takes different forms, including individuals and businesses that** (1) engage in taxable transactions without having registered with the tax authorities, (2) fail to file their tax returns by the statutory filing deadline, (3) underreport their tax liabilities or illicitly claim tax refunds, or (4) underpay the amount of taxes due (tax arrears).⁶ These forms of noncompliance give rise to a *tax gap* representing foregone government revenue; reducing this gap is an integral task for tax agencies both in good and bad economic periods.⁷

6. **Although some aspects of taxpayer compliance may actually improve during an economic downturn, there is good reason to believe—as many tax administrators do—that compliance will worsen in important respects.** The basic models of income tax compliance suggest compliance might in some respects improve as incomes fall during a recession, both because individuals may become less willing to take the risk involved in cheating on their taxes⁸ and as a consequence of progressivity in the tax code.⁹ The latter means that a reduction in income implies a lower marginal tax rate—which leaves a smaller gain from and, hence less incentive for, not declaring that income. Thus, some taxpayers' compliance may actually improve. Other considerations, however, clearly point to an increased risk of noncompliance:

- When credit is tight or unavailable, credit-constrained taxpayers may be tempted to use tax evasion as an alternative source of finance for their operations. For example, businesses may fail to remit to the government the taxes they have withheld from their customers (value-added tax—VAT) or employees (payroll taxes).
- Taxpayers who face severe economic stress—such as the risk of bankruptcy—may perceive the downside risks of tax evasion (penalties) to be minimal compared with the potential upside gains (avoiding bankruptcy). Indeed it can be shown, for

⁶ Noncompliance also involves tax avoidance schemes through which taxpayers aim to reduce their tax liabilities by means of arrangements that may be legal but usually contradict the intent of the law they purport to follow.

⁷ See Brondolo, Silvani, Le Borgne, and Bosch (2008).

⁸ In the benchmark model of Allingham and Sandmo (1972), a fall in income leads to reduced evasion—both absolutely and relative to income—if, as is normally assumed to be the case, relative risk aversion increases with decreases in income.

⁹ Slemrod (2001).

instance, that if the bankruptcy costs are large enough, this effect—gambling for resurrection by becoming less tax compliant—can outweigh the progressivity consideration noted above.

- If an economic crisis leads to a shift in economic activity from the formal to the informal sector, compliance is likely to decline, since it is widely recognized (virtually by definition) that the rate of noncompliance is much higher in the informal sector.

These conditions, moreover, may be reinforced by social norms: in a recession, taxpayers may perceive (1) the tax agency to be less stringent in enforcing the tax laws or (2) that other people are evading taxes more, making it less risky or more socially acceptable to evade taxes themselves.

7. **Empirical evidence on the impact of recession on taxpayer compliance is sparse, but tends to confirm the likelihood of some worsening.** The most comprehensive empirical study on the determinants of individual income tax compliance in the United States (Plumley, 1996) found that taxpayers' filing and reporting compliance are negatively correlated with the unemployment rate.¹⁰ There is also evidence that credit constraints reduce taxpayer compliance. A recent study of close to 190,000 Chinese industrial firms (Cai and Liu, 2009) shows that corporate income tax evasion is negatively correlated with access to credit, suggesting that compliance can be expected to decline when an economic downturn is combined with tight credit conditions. Another recent study (Schneider, 2009) reports that the ongoing crisis will increase the shadow economy in 21 Organization for Economic Development and Cooperation (OECD) countries by an average of 0.5 percent of GDP during 2009 after a decline each year since 2001.¹¹ Finally, an ongoing study by the IMF's Fiscal Affairs Department has found evidence that VAT compliance tends to worsen as the (negative) output gap grows.¹²

8. **The balance of evidence, as set out above, suggests that compliance could reasonably be expected to decline during the ongoing crisis.** It is even more probable that the crisis will shift the incidence of noncompliance toward the sectors most affected by the downturn¹³ or cause some forms of noncompliance to become more pronounced. Both

¹⁰ In the U.S. study, filing compliance is measured by the percentage of tax returns that are filed on time, whereas reporting compliance is defined as the proportion of income reported by taxpayers and the amount of personal income in the national income accounts.

¹¹ Schneider estimates the shadow economy in 21 OECD countries to have been equivalent to (an unweighted) 16.7 percent of GDP in 2001, 13.3 percent of GDP in 2008, and 13.8 percent of GDP in 2009.

¹² See Section IV.B below.

¹³ In some countries, the real estate, finance, and automobile sectors have been hit particularly hard by the crisis.

situations—the possibility of compliance decline and the probability of a shift in the incidence of noncompliance—warrant the attention of tax agencies.

9. **A drop in taxpayer compliance may have some countercyclical effects on the economy, but complicates fiscal management, and tolerating noncompliance is not an appropriate response to the crisis.** Tax-based automatic stabilizers and discretionary tax policy changes can help dampen the negative effects of an economic downturn. For this same reason, it could be argued that tax agencies should condone higher levels of noncompliance during a crisis, since this could provide an additional boost to the economy. Indeed, such a weakening of compliance has some attractive features in purely countercyclical terms, especially where formal automatic stabilizers are weak: it is relatively quick acting (no legislative changes are needed) and it may be self-targeted in the sense that those most in distress will presumably be most likely, all else equal, to become less compliant. There are, however, many serious objections to this argument. If a fiscal expansion is required, and there is sufficient fiscal room, stimulus is best provided in a transparent and rule-based manner, not by allowing some taxpayers to get away with noncompliance, which would be unfair and distortionary. Moreover, and perhaps most important, the revenue decline might not be temporary, because once noncompliance becomes entrenched within the taxpayer population it tends to carry forward to future periods. This would make it harder to rebuild the tax bases as the economy rebounds, which may be needed to support fiscal consolidation over the medium-term.

B. A tax compliance strategy for the crisis

10. **To address the emerging challenges to revenue administration, tax agencies should develop a *tax compliance strategy* for the economic crisis.** Like all good strategies, this should be based on clear objectives and an appropriate set of measures for achieving them.

11. **A tax agency's fundamental objective during an economic crisis should be to *contain a rise in noncompliance*.** If left unchecked, the rising tide of noncompliance could lead to substantial foregone revenue as well as provide an unfair competitive advantage to noncompliant businesses. Containing noncompliance in a crisis requires tax agencies to adjust their taxpayer services and enforcement program for newly emerging compliance risks.

12. **A second objective should be to help taxpayers cope with the pressures of the crisis.** During a crisis, many viable businesses can be expected to experience severe financial stress that could cause them to cease their operations and exit the tax system, resulting in permanent revenue losses. Measures that could enhance the probability of taxpayers staying in the tax system include adjusting advance payments, accelerating tax refunds, and making greater use of payment extensions. To the extent that these measures provide an element of

fiscal stimulus, decisions on their introduction should be made at an appropriate level within the government and factored into the country's overall economic program for the crisis.

13. **To achieve these objectives, supporting measures are needed.** These can be grouped under four pillars:

- expanding assistance to taxpayers,
- refocusing enforcement on the emerging areas of noncompliance that pose the greatest risk to revenue collection,
- enacting legislative reforms that facilitate administration, and
- improving communication with the taxpayer population.

Although these pillars apply broadly in normal economic times, what distinguishes them in a crisis is that their underlying measures should be focused on issues specific to the crisis.

14. **The measures should be tailored to the compliance risks in each country.**

Subsequent sections provide examples of measures that some tax agencies are implementing in response to the crisis. These are not meant to be exhaustive or prescriptive for all countries, but instead illustrate the types of actions that countries may consider. Before proceeding, it is worth making several preliminary points.

15. **First, early warning for shifts in taxpayer compliance is crucial for prevention.**

The sooner a tax agency can identify an up tick in noncompliance, the faster it can respond. Few tax agencies, however, have the capacity to estimate the precise level of the overall tax gap. In this situation, tax agencies should identify and track compliance indicators that can be more easily measured, such as increases in late filing of tax returns, growth in tax arrears, and taxpayers' attitudes toward compliance as measured by surveys.¹⁴

16. **Second, tax agencies should establish a high-level group to coordinate the development of the tax compliance strategy.** This group, which could be either an ad hoc or permanent body, should comprise the tax agency's senior management, include a small staff, and interact closely with the operational departments. Its main responsibilities should be to confirm the emerging revenue risks, coordinate the development of appropriate treatments for these risks, ensure that the compliance strategy is properly planned and resourced, and monitor results. Although such a high-level group should also exist in normal times, it needs to operate in a more proactive, streamlined, and focused manner during a crisis.

¹⁴ Some tax agencies also estimate the tax gap for the VAT using national accounts data, which is considerably easier to calculate than the tax gap for income taxes.

17. **Third, government support for tax administration is critical during the crisis.** Like all government agencies, tax agencies face the prospect of declining budget allocations in an economic downturn as governments seek to create fiscal room for high-priority social expenditures. However, it should be recognized that the task of tax administration becomes more demanding during difficult economic times. In this situation, substantial cuts in tax agencies' budgets are likely to reduce the effectiveness of tax collection and further aggravate a decline in revenue.

18. **Finally, tax agencies should align their near-term compliance strategies and medium-term modernization plans.** Sustaining revenue collection over the medium term will require tax agencies to address their most fundamental weaknesses (e.g., poor organizational and staffing arrangements, weak taxpayer services and enforcement programs, and outdated information systems). By their nature, such problems can be addressed only over the medium term, but in developing a compliance strategy for the economic crisis, tax agencies should not neglect their medium-term goals.

III. EXPANDING ASSISTANCE TO TAXPAYERS

19. **The first element in a tax compliance strategy for an economic crisis is to expand assistance to taxpayers.** Providing strong support to individuals and businesses is critical to containing noncompliance and keeping taxpayers in the system. To this end, tax agencies should review and adjust their full range of policy instruments, services, and information products. Five measures are of particular importance:

- ensuring the smooth implementation of government tax initiatives, particularly those involving stimulus programs;
- adjusting advance tax payments to reduce taxpayers' cash-flow pressures;
- accelerating the issuance of tax refunds, subject to proper risk management;
- making greater use of payment extensions; and
- providing targeted and proactive assistance to high-risk taxpayers.

20. **Some forms of taxpayer assistance are counterproductive and should be avoided.** In an effort to help taxpayers cope with the crisis, some countries are considering the implementation of tax amnesties, moratoria on auditing taxpayers, and other similar measures. International experience has shown that such measures are not effective tools for improving revenue collection and create perverse incentives for currently compliant taxpayers to stop complying with the tax laws (Baer and Le Borgne, 2008).

A. Implementing government tax initiatives

21. **A number of tax agencies have been required to implement tax-based stimulus initiatives.** These initiatives commonly include tax rate cuts, new credits, and rebates. Recent experience from the United States offers lessons in implementing such measures. In 2008, the United States enacted the Economic Stimulus Act (ESA), which provided tax rebates to low- and middle-income households. ESA mandated that the Internal Revenue Service (IRS) begin issuing more than 100 million stimulus payments within about 12 weeks of its enactment on February 13, 2008.

22. **The IRS is considered to have successfully implemented the 2008 tax rebate program, though at some cost to other activities.**¹⁵ As of September 2008, it had issued more than 117 million stimulus payments, with a payment accuracy rate of 99.6 percent, totaling US\$94 billion, and responded to more than 118 million telephone calls relating to the payments. Despite this general success, some complications arose during the implementation process, stemming mainly from the program's tight implementation schedule, which did not provide the IRS with sufficient time to hire, conduct background checks, and train additional staff for various aspects of the program. Instead, the IRS shifted hundreds of staff from arrears collection activities to telephone services for refunds. Nonetheless, the level of telephone service (defined as the percentage of calls answered by an IRS representative) dropped sharply from the filing season target of 82 percent to 50–55 percent. In addition, the reallocation of staff from arrears collection is estimated to have resulted in some US\$650 million in foregone arrears recovery.

23. **The IRS' experience points to a number of lessons that should be considered when designing a tax rebate program.** First, tax rebates can be handled more easily in countries where individual refunds are a normal part of the tax system. Second, the complexity of implementing a tax rebate program varies with the intricacies of the rules for determining eligibility and the amount of the tax rebate. Third, a tax rebate program can be implemented more easily and effectively outside the peak period for filing tax returns. Fourth, a rebate program requires a comprehensive taxpayer register with sufficient data to determine eligibility.¹⁶ All these lessons confirm the importance of adequately designing, planning, and managing a tax rebate program.

¹⁵ See MITRE Corporation (2008) and GAO (2008).

¹⁶ Such a register is more common in countries that require most people to file an annual tax return (e.g., Australia, Canada, United States). In countries where the tax agency does not maintain a universal taxpayer register, the tax agency will need to acquire the registration information from another source (e.g., social security agency).

B. Adjusting advance payments

24. **Some advance payment programs may exacerbate taxpayers' cash flow problems during an economic downturn.** In most tax systems, businesses and the self-employed individuals must make advance income tax payments during the year and a final payment at year-end. If advance payments are calculated on the basis of the previous year's tax liability, an economic downturn will generally cause advance payments to be higher than necessary, thereby aggravating taxpayers' cash flow pressures.

25. **To mitigate this problem, advance payments could be adjusted to more closely approximate the taxpayer's final tax liability.** For example, payments could be calculated as the product of current period sales and the ratio of the previous year's tax liability to sales. Alternatively, taxpayers could be permitted to calculate their advance payments, not based on the previous year's liability, but instead by estimating revenue and expenses for the current year. In the latter case, the tax laws should (as they commonly do) impose a penalty if advance payments prove to be significantly lower than the full-year tax liability.

26. **A number of countries are taking steps in this direction.** For example, Chile's advance payment system requires businesses and self-employed persons to calculate advance payments as a fixed percentage of their current period sales. In applying this rule in 2009, the authorities will allow taxpayers to reduce the amount of advance payments by 15 percent if their gross income was equal to or less than about US\$3.6 million in 2008 and by 7 percent if gross income was above this threshold or if the business started operations after January 1, 2008. Similarly, Australia reduced its pay-as-you-go tax for qualified small businesses by 20 percent for the quarter that includes December 31, 2008.

C. Accelerating the issuance of refunds

27. **Tax refunds can provide vital cash flow relief to financially distressed taxpayers.** Recognizing this, some tax agencies have accelerated issuance of all or part of tax refunds. For example, Chile has recently introduced a reform allowing individuals to receive part of their personal income tax refund six months before the close of the tax year, with the balance issued at the end of the tax year.¹⁷ Poland has recently reduced the statutory deadline for issuing VAT refunds from 180 to 60 days. In a similar move, the United States has liberalized the refunding of losses: small businesses are now permitted to carry back their net operating losses to get a refund of taxes paid over the past five years instead of the usual two.

28. **Tax refunds can be issued more quickly by streamlining refund management processes.** This can be done by assigning priority to processing tax returns that involve a

¹⁷ Specifically, taxpayers are entitled to receive an advance refund of 50 percent of the average refund received in the three most recent tax years.

refund claim, temporarily reallocating staff to refund operations from other activities and eliminating the requirement to audit all refund claims (where such a practice is required). To reconcile the objectives of accelerating refunds and avoiding fraudulent claims, some tax agencies are adopting (or refining) risk-based systems to select the most questionable claims for audit and are also making greater use of post-refund audits (where the claim is audited after the refund has been paid) for lower-risk claims while reserving pre-refund audits (where the claim is audited before the refund is paid) for higher-risk claims.¹⁸

29. **Regrettably, some governments routinely delay the payment of refunds without proper cause and without subsequent payment of interest.** In some cases, the delays appear to be a deliberate policy decision of using refund arrears to help achieve the government's budget targets and cash flow objectives. In other cases, the payment arrears reflect poor administrative processes. Either way, such practices are highly counterproductive in that they aggravate taxpayers' cash flow problems at the worst possible time and encourage them to withhold tax payments from the government. To avoid these problems, governments should make adequate budgetary provisions for refund payments.

30. **Cash flow relief can also be provided by deferring VAT payments for imported capital goods.** On this issue, some countries allow registered VAT taxpayers, who meet certain standards, to defer VAT payment for large amounts of imports of capital goods. The details for such programs are spelled out in Ebrill (2001; Chapter 15). It should be noted, however, that deferral schemes are subject to abuse and revenue leakage if not carefully administered. Therefore, they are best implemented in countries with strong revenue administrations and should be restricted to taxpayers with proven compliance histories and who post a financial security (e.g. a bond).

D. Making greater use of payment extensions

31. **Installment arrangements provide an important tool for collecting tax revenue from cash-strapped taxpayers.** The tax laws in many countries include provisions that allow financially distressed taxpayers, under certain conditions, to pay their tax liabilities in installments. The installments typically span one to two years during which time interest accrues but late payment penalties are usually waived. Such arrangements help promote compliance because they allow the tax agency to bring a tax debt quickly under control and usually require the taxpayer to stay current with all future tax payments; failure to do so results in the plan's termination and severe collection actions.

32. **During a crisis, when increasing numbers of taxpayers face serious cash-flow problems, a case can be made for greater use of installment arrangements for viable businesses.** By extending the timing of payment, installments have the potential to recover

¹⁸ Approaches for combating refund fraud are described in Section IV.B and Appendix 2.

more revenue from distressed taxpayers over the medium term and to keep viable businesses afloat. The Inland Revenue Authority of Singapore provides a good example of introduction of an enhanced installment program during a financial crisis (Appendix 1).

33. In some countries, the effective use of installment arrangements is constrained by legal requirements or administrative practices that allow them only after exhausting all other efforts at recovering the tax. To overcome this, criteria could be established under which a taxpayer would be automatically entitled to an installment plan. These could include the following:

- The taxpayer has submitted a financial statement that demonstrates (1) the viability of the business and (2) an inability to fully pay the tax liability in the short term.
- The amount of the tax liability does not exceed a prescribed threshold.
- The taxpayer has filed all tax returns, has not failed to pay any tax within the past three years, and has not recently entered into an installment plan.

In this connection, Hungary has recently granted all individual taxpayers (physical persons) an automatic right to an installment plan for tax debts less than Ft 100,000 (approximately €340), which must be paid in equal monthly installments over four months.

E. Providing targeted and proactive assistance

34. In responding to the crisis, some tax agencies are providing more targeted and proactive assistance to taxpayers. Targeted assistance aims at focusing the tax agency's limited resources on taxpayers and tax issues that present significant compliance risks as a result of the crisis. Proactive service delivery also becomes more important in an economic downturn because taxpayers at the highest risk for noncompliance are frequently the most reluctant to seek the tax agency's assistance. Two good examples of this approach are the Australian Taxation Office (ATO) small business program and the IRS volunteer income tax assistance program.

35. The ATO *Small Business Assistance Program*, created in 2007, provides targeted assistance to small businesses at various stages of the business' life cycle. It aims to help businesses understand their registration requirements and how to comply with their tax obligations (particularly VAT and employer withholding) and improve their business record keeping. The program has recently been refined to provide more proactive assistance to high-risk taxpayers, including by sending text message reminders to previous late filers in particular demographic groups. In the current crisis, the program is being further refined by using the ATO's profiling capabilities to identify taxpayers considered at risk for financial distress and contacting them by telephone to offer assistance *before* they have failed to meet a tax obligation.

36. **The ATO approach is based on the premise that preventing noncompliance is more cost effective than curing it.** ATO has found that if it waits for the normal enforcement cycle to run its course—for example, by issuing a series of reminder letters to taxpayers who have missed a filing or payment date—too many taxpayers will fall too far behind in their taxes for there to be much chance of recovering the revenue. The ATO approach mirrors a key lesson learned by leading companies in emerging markets when faced with an economic downturn: keeping existing customers is a lot easier than trying to attract new ones (Roth and Ettenson, 2009).

37. **Tax agencies may need to provide additional tax services to offset the decline in the use of professional tax advice.** Developments in the United States suggest that taxpayers are cutting back on their use of professional tax advice in the face of the economic decline. In a recent media release, the largest U.S. tax return preparation company reported that for the period ended April 15, 2009, total tax returns prepared fell by 667,000 returns (H&R Block, 2009b). The company believes that this shift is driven primarily by increased price sensitivity of taxpayers because of current economic conditions (H&R Block, 2009a).

38. **Some tax agencies are relying on volunteers to meet the growing demand for tax services in the face of a fixed budget.** For example, the IRS operates the Volunteer Income Tax Assistance (VITA) program, which offers free tax help to low- to moderate-income (generally, US\$42,000 and below) people who cannot prepare their own tax returns. Under this program, certified volunteers sponsored by various organizations receive training to help prepare basic tax returns. VITA sites are located at community and neighborhood centers, libraries, schools, and shopping malls. The number of tax returns prepared under the VITA program increased by about 2.2 percent during the 2009 filing season, which helped offset some of the decline in tax returns prepared by private sector tax professionals.

39. **Targeted assistance is also required for large businesses.** Although large taxpayers usually possess sufficient expertise to address most tax issues, the crisis may raise many new issues. For example, tax losses, payouts to laid-off workers, and capital-raising operations all involve tax issues that are particularly relevant to the large-taxpayer segment in an economic downturn. To avoid a possible misapplication of the tax law, tax agencies should proactively convey their positions on these issues to large taxpayers through e-mail alerts, websites, and discussions with corporate executives and tax professionals.

IV. REFOCUSING ENFORCEMENT

40. **A tax compliance strategy for the economic crisis also needs to adjust enforcement programs for emerging compliance problems.** Controlling noncompliance in a crisis environment will require enhanced enforcement in six directions (with the varying specific emphasis, depending on country circumstances):

- safeguarding revenue from the largest taxpayers by reassessing the controls over this segment in light of the crisis,
- intensifying arrears collection,
- securing tax withholding,
- giving greater attention to loss-reporting businesses,
- enhancing the scrutiny of cross-border transactions and offshore evasion, and
- containing the growth of the cash economy.

A. Safeguarding revenue collection from large taxpayers

41. **Ensuring tight control over large taxpayers should be considered a top priority by tax agencies during a crisis.** In almost every country, a relatively small number of taxpayers collectively account for the largest portion of tax revenue. This revenue concentration poses a particularly significant risk in a crisis, since a decline in compliance by just a few large taxpayers can lead to large amounts of foregone revenue.

42. **To reduce the risks posed by large businesses, tax agencies should reassess their controls over this taxpayer segment by**

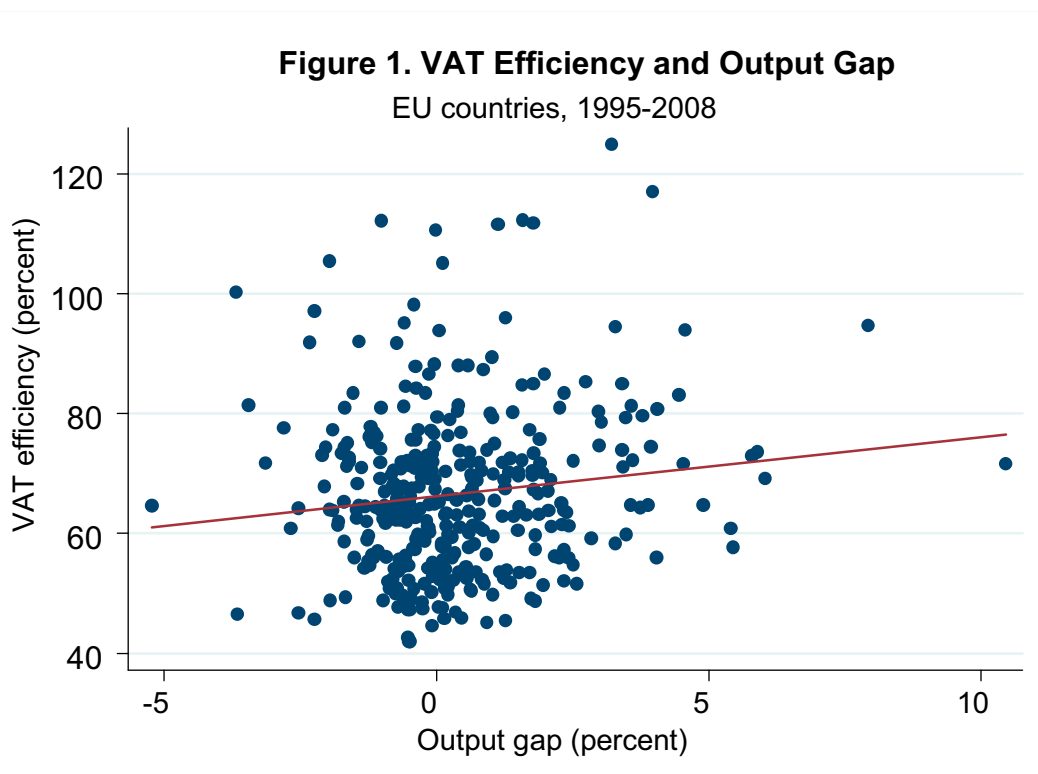
- consolidating the number of large taxpayer offices (LTO) and ensuring that they report directly to a senior headquarters official instead of through a regional tax office;
- reviewing the selection criteria for assigning taxpayers to the LTO to ensure that the LTO controls, say, at least 60 percent of the tax base;
- increasing the number of LTO staff, particularly auditors, in line with any increase in the number of taxpayers assigned to the LTO;
- shifting the focus of the LTO audit program toward industries most affected by the crisis and making greater use of issue-specific audits to broaden audit coverage; and
- introducing or expanding the use of industry specialists at the LTO, including for financial products, valuation, and computer-aided audit methods as well as for complex issues that span industries, such as transfer pricing, thin capitalization, and tax losses.

B. Securing tax withholding

43. **Withholding taxes present a high risk to revenue collection during a crisis.** This is because increasing numbers of credit-constrained businesses can be expected to illicitly

retain the taxes they withhold from their customers (VAT) or employees (payroll taxes) to finance their ongoing operations.

44. **VAT efficiency—a measure of the effective coverage of the VAT—tends to decline during an economic downturn, which is suggestive of a decline in VAT compliance.** A panel regression of the VAT C-efficiency ratio on the output gap points to a positive and significant correlation between the two variables for European Union countries during 1995–2008 (Figure 1).¹⁹ Furthermore, there is a positive correlation for the majority of the countries in the sample, when each country is examined separately. The positive correlation may reflect a decline in taxpayer compliance during an economic downturn.²⁰



Sources: Eurostat; and IMF staff estimates.

¹⁹ C-efficiency is defined as the ratio of VAT revenue to consumption per point of the standard VAT rate; a positive output gap means output above trend.

²⁰ The decline in VAT C-efficiency could also reflect shifts in consumption patterns. For example, as incomes go down, the share of consumption of “necessity” goods, which tend to be taxed at a low rate, goes up.

45. **Because tax withholding accounts for a large revenue share in many countries and payment of these taxes to the government tends to decline in a crisis, tax agencies should take steps to strengthen enforcement in this area.** Measures could include broadening audit coverage for tax withholding, assigning higher priority to recovery of arrears involving these taxes, enhancing the exchange of information with other agencies (e.g., customs, social insurance funds) that play a role in administering tax withholding, and reviewing or increasing penalties.

46. **The VAT refund mechanism is particularly vulnerable to abuse during a crisis, since increasing numbers of cash-constrained businesses may be tempted to file illicit refund claims.** A tax agency's capacity to prevent fraudulent claims, while ensuring the timely issuance of legitimate ones, depends on a well-designed and -executed audit strategy. This involves a few simple principles: (1) distinguishing between refund claimants with a good compliance history and those with poor or unknown compliance histories, (2) using pre-refund audits for high-risk refund claims and post-refund audits for claims of lower risk, (3) applying analytical criteria to determine the likely extent of revenue risk associated with each refund claim, and (4) focusing the scope of a refund audit on issues material to the refund claim (see Appendix 2).

C. Intensifying arrears collection

47. **Tax arrears tend to rise sharply during an economic downturn.** Tax agencies should consider liberalizing the use of payment arrangements to assist distressed taxpayers (see Section III), but firm enforcement action should be taken against businesses that have the capacity to pay their taxes but refuse to do so.

48. **Good debt collection practices are even more important during a crisis.** This is because the window for collecting tax debts may close more quickly in a recession, when taxpayers' cash-flow problems worsen and bankruptcies increase.²¹ In this situation, it is essential for tax agencies to (1) ensure early detection of tax arrears and establish appropriate time standards for follow-up, (2) maintain the quality and timeliness of tax arrears data, (3) target enforcement efforts on recoverable arrears—usually by focusing on the most recent and largest arrears first, (4) leverage the telephone context center to place outgoing debt collection calls, (5) write off arrears deemed unrecoverable, (6) implement proper organizational and staffing arrangements for collection enforcement, including a greater organizational focus for large tax debts, and (7) be vested with a full set of enforcement powers.

²¹ International experience has shown that the probability of debt recovery declines rapidly when a debt remains outstanding after 60–90 days.

49. **In addition, tax agencies need to give greater attention to recovering tax arrears from bankrupt companies.** Bankruptcies present many challenges to debt recovery because the collection process is normally taken out of the tax agency's direct control and placed under a country's bankruptcy judicial system. To address these complexities, some tax agencies are allocating more enforcement staff to bankruptcy cases; others are creating a special bankruptcy unit within their debt collection departments. Some, like those in Denmark, are working to improve coordination between the tax agency and the bankruptcy court.

50. **The number of taxpayers who fail to file a tax return can also be expected to rise during an economic downturn.** To cope with this problem, tax agencies should make greater use of *default* assessments²² in determining the tax liability while reserving audits (which are more time consuming and difficult to estimate) for larger nonfiling cases. To avoid the risk that default assessments will lead to large amounts of uncollectible tax debts, the assessments should be screened for reasonableness before being issued to taxpayers.

D. Giving greater attention to loss-reporting businesses

51. **Tax laws often include provisions that provide some relief for losses.** Most countries allow losses to be carried forward and offset against future income. Some countries also permit losses to be carried back and refunded against taxes paid in earlier periods. In addition, a number of countries allow losses to be transferred between firms in the context of a merger. These provisions can provide a lifeline to distressed businesses as well as facilitate corporate restructurings.

52. **In an economic crisis, tax losses present a growing compliance risk.** Some businesses may declare illicit losses, believing that the tax agency cannot distinguish them from bona fide losses in a general environment of decreased profitability. Failure to control losses may put significant revenue at risk (loss carry forwards can generate tax deductions for many years to come, loss carry backs can lead to immediate refunds, and loss transfers may encourage inefficient trafficking in the sale of loss-making companies).

53. **While permitting bona fide loss claims, tax agencies should give greater attention to possible abuses by** (1) verifying doubtful claims, particularly in cases of larger claims, (2) determining whether the conditions and limitations have been correctly applied for carrying forward, carrying back, and transferring losses, and (3) checking for possible manipulation of losses by consolidated groups and partnerships. More generally, tax agencies need to sharpen their audit focus on businesses that report tax losses year after year.

²² Default assessments establish the amount of tax owed by using information already available to the tax office, such as by charging a multiple of the previous period's tax assessment.

E. Enhancing the scrutiny of cross-border transactions

54. **The crisis has brought cross-border compliance issues into sharper focus.**

Globalization has been accompanied by a rise in international tax compliance issues, ranging from legitimate but highly complex cross-border tax planning to deliberate concealment of income and assets in tax havens. With the crisis, a number of tax agencies are strengthening their enforcement efforts against cross-border noncompliance, including the abuse of offshore tax centers.

55. **Shifting offshore losses through nonmarket pricing is of growing concern.** Recent market events have led to losses, or lower-than-expected profits, for many multinational groups. These groups will find incentives to report their losses in countries where they can be used to best advantage (i.e., high-tax jurisdictions). In this situation, some tax agencies are paying more attention to the illicit importing of losses through nonmarket pricing. For example, increases in inbound management service charges with a view to recovering increased global costs—without regard to the specific nature of the services received in the home country and the related arm's length value of those services—are being more closely reviewed.

56. **Tax avoidance schemes involving repatriated funds are receiving increased attention.** Some tax agencies believe the crisis will create additional pressure for local subsidiaries to repatriate funds to overseas parents. In addition to transfer-pricing concerns, this may lead to adoption of aggressive tax practices concerning nonresident tax withholding and foreign tax credit regimes. Similarly, a number of tax agencies have pointed out that during previous recessions money was brought back from offshore bank accounts to support small and medium-size businesses, which required investigation.

57. **The crisis has also drawn attention to international tax evasion involving offshore tax havens.** In recent years, a significant increase in offshore activity has been noted by some countries. For example, U.S.-based corporations more than tripled their total foreign profits between 1994 and 2004, with 58 percent of that profit earned in low-tax or no-tax jurisdictions (IRS, 2008a). The large amount of offshore assets combined with tax havens' limited cooperation on tax matters has raised concerns that substantial tax revenue may be at risk, either through unintended loopholes that allow companies to legally avoid paying taxes or through the illegal use of hidden accounts by individuals. These concerns have intensified with the deteriorating fiscal balances in a number of countries.

58. **At their April 2009 meeting in London, G-20 leaders called on countries to adopt the international standard for exchanging tax information (G-20, 2009).**²³ At the same

²³ The internationally accepted standard, developed under the auspices of the OECD, requires exchange of information on request in all tax matters for the administration and enforcement of all domestic tax law without regard to a domestic tax interest requirement or bank secrecy for tax purposes. It also provides safeguards to

(continued)

time, they made clear that they stood ready to take action against jurisdictions that do not meet the international standard. To this end, G-20 countries have agreed to develop a toolbox of countermeasures against noncooperative jurisdictions, including increased disclosure requirements on transactions involving noncooperative jurisdictions, tax withholding on a wide variety of payments, and denial of tax deductions for expense payments to payees resident in a noncooperative jurisdiction.

59. **In the lead-up to and aftermath of the London meeting, a raft of additional countries (including several tax haven countries) committed themselves to adopting the international standard for exchanging tax information.**²⁴ For these countries, the priority now shifts to fully implementing their commitments by swiftly negotiating, concluding, and introducing tax information exchange agreements or through the exchange of information articles of double-taxation agreements. A key issue here is to ensure that non-OECD countries share with OECD countries in the benefits of the new cooperative tax environment.

60. **In this situation, additional countries should adopt and fully implement the international standard for exchanging tax information.** It is recognized that some low-income countries may face many difficulties in implementing the international standards and responding to requests for information. These countries may require support from the international community, through technical assistance and/or cost-sharing arrangements, in order to effectively fulfill their commitments to exchange tax information.

61. **In addition, tax agencies should strengthen their international enforcement programs** by (1) developing a targeted audit program to address cross-border evasion; (2) expanding the number of audits of international issues, increasing the number of international tax auditors (particularly within the LTO), and providing greater technical guidance to auditors on international issues; (3) increasing disclosure requirements on international transactions;²⁵ (4) publishing warnings on specific international tax planning

protect the confidentiality of the information exchanged. This standard was endorsed by the G-20 in 2004 and is reflected in the UN Model Tax Convention. See G-20 (2009).

²⁴ As of June 24, 2009, the OECD reported that all 84 countries surveyed by the Global Forum on Transparency and Exchange of Information have agreed to the internationally accepted standard, and more than half have substantially implemented it (OECD, 2009).

²⁵ Disclosure requirements may involve resident taxpayers' foreign transactions and/or their relationship with foreign affiliates. Regarding foreign transactions, some tax agencies require taxpayers—when seeking a deduction in their tax return for payments of interest, royalties, and with respect to patent rights, trademarks, etc.—to report the name of the country to which these payments have been made and the amount of the payment. In addition, some tax agencies require taxpayers to report new offshore bank accounts, the establishment of foreign trusts, or the acquisition of foreign property. Regarding foreign affiliates, a number of tax agencies require corporations to include in their tax return a list of nonresident related or associated corporations with which there were transactions during the year. It must be indicated on the list, for each

(continued)

schemes that are deemed to improperly exploit loopholes in the tax laws; (5) promoting the exchange of information with the country's anti-money-laundering agency to verify compliance and identify aggressive international tax practices;²⁶ (6) entering into tax information exchange agreements with other jurisdictions and effectively using this information for control purposes; and (7) introducing a voluntary disclosure program that encourages taxpayers to declare previously unreported income in offshore accounts.²⁷ Regarding the latter, voluntary disclosures represent permanent programs (which are better described as part of the penalty structure) and should be distinguished from one-off tax amnesties, which suffer from many drawbacks.²⁸

F. Containing the cash economy

62. **The cash (shadow) economy represents an increasing risk to tax collection.** As mentioned earlier, Schneider (2009) indicates that the cash economy will increase in OECD countries by an average of 0.5 percent of GDP during 2009 as increasing numbers of persons attempt to make up for lost income in the formal economy through greater participation in the cash economy. If this development materializes, significant amounts of revenue could be put at risk, since taxpayers' compliance rates in the cash economy are substantially lower than in the formal economy (GAO, 2007).

63. **Tax agencies that have succeeded in containing the cash economy have done so on the basis of a multifaceted strategy that includes** (1) identifying high-risk sectors and developing an understanding of taxpayer behavior in those sectors, (2) encouraging compliance through proactive and innovative measures, (3) an escalated regime of enforcement methods, and (4) partnerships with relevant civic associations that may influence cash economy businesses. The ATO's cash economy strategy is a good example of this approach (Appendix 3).

corporation, the approximate total of intercompany sales and purchases and amounts paid or received for services.

²⁶ For example, the ATO uses reports from Australia's anti-money-laundering agency (AUSTRAC) to (1) profile individual industries, occupations, and geographical areas; (2) identify potentially high risk transactions; and (3) select cases for further investigation.

²⁷ In the United States, the IRS introduced a voluntary disclosure program in 2009 that offers a reduced civil penalty and a likely waiver of criminal charges for taxpayers who (1) voluntarily disclose unreported offshore income and pay all taxes and interest going back six years, (2) file or amend their tax returns, and (3) pay a penalty equivalent to 20 percent of the value of an offshore account during the tax year in which it had its highest value.

²⁸ Baer and Le Borgne (2008).

64. **A tax agency's response to the cash economy should be proportionate to the magnitude of the problem.** While taking steps to contain the cash economy, tax agencies should not lose sight of the fact that other compliance challenges—such as those involving large taxpayers and cross-border issues—may present larger revenue risks.

V. REFORMING LEGISLATION

65. **A third element in a tax compliance strategy for the crisis is legislative reform.** Although it is generally not advisable to implement comprehensive tax reform in the midst of a crisis—which could add uncertainty to a country's business climate—some targeted changes in legislation may facilitate the tax agency's response. Some of the reform priorities in this area were highlighted in earlier sections of this paper.²⁹ Other important provisions include the following:

- To better address cross-border compliance risks, transfer-pricing rules may require strengthening (including, possibly, through the enactment of a general anti-avoidance rule).
- To address taxpayers' payment problems, tax agencies should have broad authority to arrange installment plans (with reasonable terms and conditions) for genuinely distressed taxpayers and enforce collection from uncooperative tax debtors, including by seizing physical and financial assets).
- To discourage nonpayment of tax withholding, tax agencies should have authority to recover tax arrears directly from corporate officers under prescribed conditions.
- To address a rise in nonfiling, tax agencies should be permitted to use all reasonable means (including default assessments and *indirect audit methods*³⁰) to assess the amount of taxes owed by taxpayers who fail to file a tax return.
- To deal with underreporting of taxes or overreporting of losses (and refunds), the tax administration needs the authority to summon a taxpayer and third parties to provide evidence and testimony on relevant tax matters.

²⁹ For example, (1) adjusting advance payment methods to reflect current economic conditions; (2) tax loss provisions that provide reasonable relief to bona fide loss-sustaining firms, but that are consistent with the tax agency's administrative capacity; (3) tax agencies that have broad authority to arrange installment plans for genuinely distressed taxpayers and enforce collection against uncooperative tax debtors; and (4) tax agencies that are vested with the power to require taxpayers to disclose additional information on international transactions.

³⁰ If the taxpayer has failed to file a return and/or the taxpayers' records are deemed inadequate to determine tax liability, the tax authorities are often authorized to assess tax on the basis of best judgment, using indirect assessment methods.

- To protect the government’s interest, country bankruptcy laws should accord tax debts an appropriate ranking in the hierarchy of a bankrupt company’s creditors.
- To enforce the tax laws, bank confidentiality restrictions should not impede a tax agency from accessing a taxpayer’s financial information held by a bank, provided such access involves a bona fide tax enforcement action and is subject to due process protections.³¹

VI. ENHANCING COMMUNICATION

66. **A special communication program for taxpayers and other key stakeholders in the tax system should aim at clearly conveying to stakeholders the various elements of the tax agency’s compliance strategy.** Tax agencies should use their full set of service channels (website, e-mail, telephone contact centers, walk-in offices) and products in publicizing their compliance strategy to the public.

67. **Communicating with taxpayers.** To promote compliance in a crisis, tax agencies need to explain to taxpayers the tax implications and steps they should take for such events as job loss, debt forgiveness, cashing in a retirement fund, and tax benefits under the government’s economic stimulus program. For instance, the IRS has posted on its website a list of *What If?* scenarios—in question-and-answer format—that provides practical guidance in responding to events that have significant tax consequences (IRS, 2008b). To dissuade taxpayers from noncompliance, tax agencies should inform the taxpayer community that they are aware of the types of noncompliance that are emerging from the crisis, explain the consequences of engaging in noncompliance (including penalties, assessment of additional taxes, seizure of assets, and, in extreme cases, prosecution), and publicize the results of actual enforcement cases.

68. **Communicating within the tax agency.** Managers and staff require timely, accurate, and specific guidance on how to apply the new policies and administrative practices under the tax compliance strategy. Internal directives and newsletters, intranet postings, senior management presentations, and training programs are all vital. For example, the Netherlands Tax and Customs Administration has issued a communication package to all regional tax offices consisting of (1) a memorandum outlining the need for specific attention to be given to emerging tax issues, (2) a questionnaire on the impact that the recession is having on the offices’ various projects, (3) an analytical report on economic sectors in financial distress,

³¹ Due process protections could include the following: limiting access to information on a specific taxpayer in relation to a specific tax issue, requiring court approval for bank information on general classes of taxpayers, subjecting requests for banking information to management review by the tax agency, and subjecting tax officers to the tax agency’s own obligations governing the confidentiality of taxpayer information and imposing penalties for violating these obligations.

and (4) information for taxpayers on the fiscal stimulus package and temporary regulations on the postponement of tax payments and other collection measures.

69. **Communicating with other stakeholders.** Tax agencies should establish or, where already established, make better use of consultations with industry associations and tax professionals (tax agents, bookkeepers, other tax intermediaries). These types of associations often have substantial influence over taxpayers' behavior and can provide the tax agency with valuable assistance in understanding crisis-driven compliance problems, developing workable solutions, and communicating the solutions to taxpayers. A good example is New Zealand's Inland Revenue Department, which launched an industry partnership program in February 2002 (Appendix 4).

VII. FINANCIAL SECTOR ISSUES

70. **Even before the current crisis, the financial sector's size and complexity made for a difficult and specialized environment for tax agencies.** Financial institutions are often one of the largest sectors in the economy, accounting for an average one-quarter of GDP among OECD countries (Zee and Schenk, 2004) and contributing substantial amounts of tax revenue. The sector comprises a wide range of entities and offers a vast array of financial products, which, over the years, have become increasingly complex in their structure and tax treatment. Moreover, many large financial institutions operate globally, making it difficult for tax agencies to get a complete picture of the institutions' overall operations.

71. **Since the onset of the crisis, the financial sector has become even more challenging for tax administration.** During 2008 and into 2009, many financial institutions have experienced large losses, some have collapsed, and others are undergoing restructuring or mergers. These developments have often been accompanied by growing tax compliance risks. Some of these risks—such as those involving tax-leveraged products and tax avoidance schemes—have been of central concern to tax agencies for some time. Others are by-products of the crisis, including valuation difficulties for illiquid assets, capital-raising operations, reported financial losses, and mergers. These compliance risks need to be kept in perspective: not all financial institutions are noncompliant and, similarly, some are shared equally by risks in enterprises in other economic sectors.

72. **Some of the largest compliance risks posed by financial institutions involve tax avoidance schemes.** In recent times, tax agencies in some countries (e.g., United Kingdom, United States) have uncovered a number of substantial tax avoidance schemes engineered by major international financial institutions. These schemes have commonly featured highly structured financial transactions, circular and cross-border flows of funds, and intra-group exchanges. Although many of these transactions are used for legitimate reasons and are also carried out by enterprises in other sectors, some appear to have been designed mainly to create artificial tax losses, inappropriate foreign tax credits, and other unintended tax

benefits. In response, some tax agencies are allocating more resources to examining high-risk avoidance arrangements engineered by financial institutions.

73. **Banks' capital-raising operations present another risk.** During the financial crisis, many banks have suffered significant declines in their capital and now need to raise additional capital to meet their regulatory requirements. In meeting these requirements, some banks may seek to raise capital through the issuance of *hybrid securities*, which contain both equity and debt features.³² For banks, some hybrids offer the advantage that they may be classified as equity for regulatory purposes and as debt (with tax deductibility of interest) for tax purposes. The misclassification of these securities, when combined with large numbers of issues, could substantially reduce the corporate income tax base. It may be that the crisis experience will dampen markets' interest in hybrids. Nevertheless, tax agencies should clearly communicate to taxpayers how hybrid securities are to be treated for tax purposes.

74. **Large financial losses incurred by many financial institutions have major revenue implications.** As mentioned in Section IV, the tax laws in many countries permit loss-sustaining firms, with limitation, to carry forward and/or carry back their losses. Tax agencies will need to carefully evaluate the losses reported by financial institutions.

75. **Mergers and acquisitions in the financial sector also raise significant issues.** In a number of countries, the financial sector is undergoing major restructuring, with some distressed firms being acquired by healthier ones. These reorganizations raise a broad range of complex tax issues, including whether the merger should be treated as taxable or tax-deferred, whether the cost basis of an acquired firm's assets can be increased, and the extent to which an acquiring firm can benefit from the tax losses (and other tax attributes) from an acquired company. Tax agencies should carefully scrutinize large-value mergers to ensure that the correct tax treatment has been applied.

76. **Valuing the financial assets reported under mark-to-market accounting presents additional complexities for tax administration.** In the wake of the financial crisis, questions have arisen on how banks should value assets in inactive markets or where the market prices reflect distressed sales. In April 2009, the U.S. Financial Accounting Standards Board issued new guidance on the conditions under which banks may value illiquid assets using "best judgment" instead of quoted market prices (FASB, 2009). This widened scope for best judgment may boost revenues now, but could create risks when normal economic conditions return. The International Accounting Standards Board announced in April 2009 that over the next six months it will conduct a comprehensive review of the accounting standards relating to financial instruments. In light of these changing rules, tax agencies in some countries will need to pay particular attention to the methods banks use to value

³² For example, a convertible bond pays interest in its early years (like debt) and at a designated time is converted into shares of stock (like equity) in the issuing company at a preannounced ratio.

financial assets. Greater cooperation between tax agencies and bank regulatory agencies may help in this regard.

77. **Gains or losses on foreclosed property may also have substantial revenue implications.** Many banks are foreclosing on large amounts of property, either through a formal foreclosure process or by voluntary conveyance of the property by the borrower. In some countries, banks are required to recognize a tax gain or loss on receipt of foreclosed property. In such cases, the gain or loss is often measured as the difference between the basis of the loan and the fair market value of the property. To guard against revenue leakage, tax agencies will need to allocate greater audit resources in validating the valuation of foreclosed property, confirming the deductible expenses taken by banks while the repossessed property is held for sale and ensuring that banks take no additional tax write-downs for bad debt on the loan after the foreclosure.

78. **Tax agencies need to provide guidance on the tax treatment of fraudulent investment schemes.** The financial crisis has also uncovered a number of fraudulent investment schemes (including so-called Ponzi schemes), some of which are reported to have resulted in huge losses for investors. Under such schemes, the perpetrator typically promises high returns—and even sometimes provides official-looking earnings statements—some or all of which are fictitious. Tax agencies need to provide guidance to the victims of these schemes by explaining (1) the treatment of taxes that were paid on fictitious income; (2) whether, how, and to what extent losses from fraud schemes are tax deductible; and (3) the supporting documentation that taxpayers must present to substantiate a claim for tax deduction. Where the losses are tax deductible, tax agencies may need to invest considerable resources reviewing the claimed deductions investor by investor.

79. **Tax agencies may use the financial crisis as an opportunity to enter into a more cooperative relationship with financial institutions** based on (1) a unilateral statement by the tax agency of how it intends to work with financial institutions, (2) a charter adopted jointly by the tax agency and all stakeholders setting out how they intend to work together, or (3) a formal agreement between the tax agency and specific bank associations (OECD 2008b). For example, the South African Revenue Service has recently entered into a cooperative arrangement with the country's banking association aimed at improving tax compliance, discouraging illicit tax avoidance schemes, and enhancing service (Appendix 5).

Appendix 1. Singapore: Managing Tax Arrears in a Financial Crisis

The financial crisis that hit east Asia in 1997 raised concerns within the Inland Revenue Authority of Singapore (IRAS) that severe liquidity problems associated with the crisis could lead many companies and individuals—even those with good tax compliance histories—to accumulate large amounts of tax arrears. To head off this problem, IRAS established a special program to give eligible taxpayers extra time to pay their tax liabilities. This program included the following measures:

- Individuals who lost their jobs were allowed to defer their tax payments for up to six months or until they found a new job, whichever came first.
- Individuals facing severe cash-flow difficulties were permitted to pay their taxes in interest-free installments, with the extension period determined on a case-by-case basis.
- Companies facing severe cash-flow problems were allowed to apply for “extended” installment plans—with or without penalty, depending on the circumstances—that could be for a period of up to 50 percent longer than that under the standard installment plan.
- Based on their cash flow, companies could pay off their tax arrears in a flexible manner, subject to late payment penalties and interest charges.

Eligibility for any of these special measures was restricted to taxpayers with good compliance histories who could produce documentary evidence that full and immediate payment of taxes would cause a genuine hardship. Importantly, enforcement officers reviewed each request for assistance on a case-by-case basis based on documentation provided by taxpayers on their financial position.

As it turned out, a relatively small number of individuals and businesses sought relief under the IRAS program, and the proportion of total tax arrears to current tax collections increased only temporarily, from 6.3 percent in 1997 to 8.2 percent in 1998, before declining to 7.1 percent in 1999. Similarly, the ratio of new flows of tax arrears to current tax collection increased by 2.1 percent, 3.0 percent, and 2.0 percent, respectively, for 1997, 1998, and 1999.

IRAS officials believe that the special debt program helped improve taxpayers’ perception of the fairness of the tax system, which, in turn, helped preserve the generally high level of compliance among taxpayers during a very difficult period. The agency has adopted similar approaches for the current global economic crisis. IRAS officials believe that being sympathetic, understanding, and flexible toward taxpayers who are experiencing real hardship would help preserve the generally high level of compliance among taxpayers during a very difficult period.

Appendix 2. Main Elements of a VAT Refund Verification Program

An effective refund verification program should provide for (1) an initial risk assessment of new VAT applicants, (2) a front-end data validation system, (3) risk-based audit selection, and (4) differentiated verification methods.

Initial risk assessment. Refund management systems should include an initial risk assessment to identify potentially fraudulent registrants. When the taxpayer first registers with the tax administration, the registration application should be compared with standardized risk profiles. *Suspect* applications should be referred for a preregistration visit by a tax officer to determine whether the location and nature of the business are consistent with the declared business activities, sources of supplies, and financing. Applications that remain suspect after the visit should be denied registration or conditions should be established for registration (e.g., posting of a security).

Front-end data validation. Refund claims should first be subjected to a front-end check of completeness (including supporting documentation), arithmetic correctness, and consistency of information before being screened for audit selection. The tax agency should have the authority to override minor arithmetic errors; more serious errors should lead to a rejection of the claim and require its resubmission by the taxpayer.

Risk-based audit selection. Once validated, refund claims should be classified into different risk-based categories (e.g., high, moderate, low) for audit selection. The criteria for establishing the rankings could include such factors as the claim's deviation from amounts claimed previously, the claimant's compliance history, whether the refund represents a first-time claim, and the date of the most recent audit. The amount of audit resources allocated to refund verifications should be consistent with the degree of revenue risk posed by refund claims relative to other compliance risks faced by the tax agency. From this perspective, an effective audit program would devote, for example, 30 percent of its audit resources to verifying refund claims and 70 percent of resources to other types of audits.

Differentiated verification methods. Different types of verifications should be applied, depending on a claim's degree of risk. *High-risk* claims should be audited prior to issuing the refund, usually at the taxpayer's premises. *Moderate-risk* claims would be assigned an upper-refund limit. Claims not exceeding the upper limit and accompanied by supporting documents would be subject to a brief desk review before the refund is issued and a post-approval audit at periodic intervals. Claims exceeding the limit would be subject to a pre-approval audit. *Low-risk* refund claims would typically be approved within 72 hours without the pre-approval audit requirement. For these claims, a post-approval audit may be arranged on a random basis from time to time.

When an audit is to be conducted, the scope of the examination should be limited to the refund claim (and not cover other tax types) and focus on issues material to the refund. Statistical sampling methods should be used to determine the number of transactions that need to be checked. Importantly, the audit should not rely excessively on export documents from Customs, since such documents are not really evidence that the goods in question were in fact exported. Instead, a sample number of export shipments should be selected and traced through purchase invoices, sales records, inventory records, shipping receipts, and payment and bank records. This would be better proof of the validity of the exports. And, if these records still leave doubt, the auditor may confirm with Customs of the importing country that the goods were properly entered for consumption.

Appendix 3. Australia: Cash Economy Strategy

The Australian Tax Office (ATO) cash economy strategy provides for a balanced set of measures to improve compliance in the cash economy, including communication measures, incentives to encourage self-service, targeted assistance, strategic alliances, and focused enforcement.

Communication measures

- targeting national and local publicity campaigns at specific high-risk sectors—for example, construction, to make potential taxpayers aware of their obligations and the potential penalties for noncompliance;
- establishing connections between business and professional associations in high-risk industries and tax practitioners to alert them to the problems caused by cash economy firms, explaining the risks and eliciting their support in combating the cash economy; and
- encouraging the community to report instances of tax evasion via a special tax evasion hotline, fax, website, and mail as well as through other government agencies.

Incentives to encourage self-regulation

- Remission guidelines for penalties and interest differentiate between taxpayers who have a good compliance record and miss an obligation on an isolated basis and those who regularly transgress.
- Less-onerous reporting requirements and extended filing periods are available for those with a record of good compliance.
- Industry benchmarks have been established for high-risk industries. These benchmarks reflect the expected relationship between inputs and outputs for a particular business activity based on industry standards. The focus is on trades where there is a strong correlation between only a few inputs and total business income.

The benchmarks are developed in partnership with the relevant industry or business association, which enhances their credibility. They are well-publicized throughout the target industry (again, in partnership with the relevant industry association). Although the benchmarks are marketed primarily as a self-checking mechanism to enable taxpayers to compare their own business performance with industry standards and to assist trade participants with voluntarily compliance by using the benchmarks as a reference point, this is complemented with a strong message that any taxpayer filing a return that varies significantly from the benchmark will be closely examined by the ATO. All returns filed by taxpayers in these industries are automatically checked against the benchmarks, and outliers are subject to risk assessment.

Targeted assistance measures

- simple information products that explain key tax obligations and inform taxpayers of how they can seek help from the tax office;³³
- free seminars conducted in conjunction with other key government agencies (e.g., social insurance) to help new businesses understand their obligations and entitlements;³⁴
- telephone calls to check whether a new business operator is experiencing any difficulties and to offer advice;
- optional free advisory visits to the taxpayer’s premises to resolve any problems that may have arisen;
- targeted advisory visits (obligatory) to the premises of new businesses that are considered high risk;
- modern and easily navigable websites that replicate the range of help and assistance products and services available to new businesses;
- provision of free electronic record-keeping software to all new businesses;
- provision of online self-help tools—for example, an online decision support system for determination of the employment status of workers (i.e., employee or contractor); and
- reminder letters, text messages, and telephone calls.

Strategic alliances

Tax practitioners. Tax practitioners are provided with a premium service that includes dedicated telephone inquiry teams, direct access to expert tax interpretation officers, and tailored seminars.

Industry and business associations. Partnership arrangements with key industry and business associations are used to identify compliance problems (e.g., ambiguous or impractical law, overly complex forms and procedures, unreasonable time limits, onerous reporting requirements, etc.) and develop workable solutions.

³³ Experience has shown that paper-based products need to be limited to a few pages at most and should be written in simple nontechnical language that the taxpayer will understand.

³⁴ These seminars usually comprise a mix of general presentations dealing with obligations and entitlements (including record keeping) common to most businesses and more tailored workshops aimed at specific high-risk industries. Industry-based seminars have been shown to achieve higher penetration when they are conducted in partnership with the relevant industry and business associations.

Business service providers. Manufacturers of accounting software packages are another leverage point for small business. Close liaison with the developers of such packages can ensure that the packages comply with all tax obligations.

Focused enforcement measures

- cross-matching tax agency information with information held by other agencies, companies, and industry bodies to identify enterprises that are not registered. For example, data from insurance, shopping center operators, and regulatory authorities have been used to identify nonreporting of cash income in various industries;
- data matching to identify individuals who appear to be living beyond their reported income. For example, ATO matches tax return data against information from government licensing bodies on luxury cars and boats;
- vesting auditors with the authority to apply indirect audit methods for reconstructing income and training staff in these methods;
- unannounced visits to the premises of high-risk taxpayers for the purpose of confirming their registration details and reviewing their record-keeping practices;
- telephoning or making personal visits to selected new businesses that fail to meet their filing obligations to ensure they understand their requirements;
- letters to businesses that report figures outside the norm, asking them to review their reported figures and ensure they are correct;
- targeted reviews and audits of taxpayers in high-risk industries resulting in the assessment of additional taxes, penalties, and, in some cases, prosecutions; and
- publicizing the results of enforcement measures to discourage others from noncompliance. For example, ATO highlights how data matching and other new approaches facilitated the detection of taxpayers operating in the cash economy and publicizes how these businesses were dealt with.

Appendix 4. New Zealand: Industry Partnership Program

New Zealand's Inland Revenue Department (IRD) launched an industry partnership program in February 2002.³⁵ The purpose of the program was to develop, test, and implement a relationship-based approach to tax administration that would help small and medium-size enterprises in selected cash economy industries to comply with their tax obligations. Industries were selected on the basis of the following criteria: average tax returns outstanding, average tax debt outstanding, and likelihood of tax discrepancies. On this basis, partnerships were formed with some 15 industries, including painting and decorating, hairdressing, plumbing, and taxi services.

The program comprised a national office team and five field teams. The national office team was responsible for overseeing the program and providing field teams with a range of support services, including design advice, research and issues gathering, relationship management with partner industries, and communication support. The headquarters team remained the primary point of contact with industry associations, facilitating the provision of guidance and advice to industry members.

The field teams consisted of an encouragement team and an assurance team, which were generally located at the same field office. Encouragement teams provided education and services about all types of taxes to taxpayers in industries covered by the program and also looked at minor tax debt and returns issues. The teams delivered a range of advisory services that included instruction on how to register for value-added tax (VAT), how to complete VAT returns, and how to maintain proper records and invoices. These services were delivered through one-on-one consultations with business operators (frequently at their place of business), seminars, and presentations at business events. The headquarters team provided the encouragement team with various supporting materials such as simplified tax brochures and booklets, information guides tailored to specific industries, templates for use at industry events, and articles for publication in industry newsletters and on websites.

The assurance teams managed compliance issues for taxpayers who failed to comply or were delinquent in their obligations. The teams included debt collection staff, intelligence officers (to identify persons operating outside the tax system), and auditors.

An IRD evaluation for five partnership industries showed the program had raised tax return filing rates and lowered tax debt in the industry groups. The study compared the trends in the five industries with trends in other (nonpartnership) industries. An external review estimated that the program achieved a 6.7 benefit-cost ratio in the five industries. A taxpayer survey indicated that the program had been well received by industry groups and had made a positive contribution toward taxpayers' compliance patterns and their attitude toward IRD.

In July 2005, the partnership program was incorporated into IRD's mainstream operations. Some of the industry partnerships were then taken over by IRD's Customer Insight Group, a new initiative designed to help improve compliance in light of the factors that influence different taxpayer groups and those outside the tax system.

³⁵ For further details, see New Zealand Controller and Auditor General (2008).

Appendix 5. South Africa: Tax Agency–Banking Association Accord

On January 29, 2009, the South African Revenue Service (SARS) and the Banking Association of South Africa signed an accord that establishes a framework for cooperation between the parties in order to improve levels of tax compliance, discourage unlawful tax avoidance arrangements, and enhance service.

By signing the accord the two parties effectively concluded an eight-year process of engagement that stemmed from serious concern on the part of the minister of finance concerning the effective tax rates of the banking industry in South Africa.

Although the long-standing informal engagement resulted in closer cooperation and improved levels of compliance, the accord seeks to further enhance the relationship between SARS and banks and provide greater clarity on the interpretation and application of tax and customs laws and the identification of tax risks.

A key feature of the enhanced relationship is the establishment of a banking-SARS forum to promote tax clarity for banks. These matters have the potential to be translated into industry standards once accepted by SARS and the Banking Association Board.

Among other things, the accord will

- Establish a guiding framework for future engagement. This framework will promote better service offerings to the banking industry while pursuing a climate of higher tax integrity.
- Strive to protect the South African tax base and level the playing field in the industry by discouraging abusive tax avoidance arrangements. This will translate into ongoing monitoring of banks' effective tax rates while providing greater tax clarity and resolution of common concerns.

In addition, the parties committed themselves to the following:

- **Banking Association**
 - regularly determining, scrutinizing, and monitoring the effective tax rate of individual banks and across the banking industry
 - raising awareness of tax governance processes to the board level within banks
 - enhancing risk management and governance processes to ensure optimal tax compliance
 - improving the quality and timeliness of information flows to SARS
 - cooperation on issues of mutual concern
- **SARS**

- offering dedicated services to the banking industry through the Large Business Centre, which will include the appointment of a taxpayer relationship manager to focus exclusively on the banking industry. Service delivery will be measured against the standards prescribed in the SARS Taxpayer Service Charter:
 - deepening its understanding of the banking industry by building technical and professional skills
 - offering an advance ruling system that is responsive and facilitates tax certainty for banks and the industry as a whole
 - promoting the highest standards of tax compliance and discouraging practices that are inconsistent with the law

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