Tax Compliance and Risk Management

Perspectives from Central and Eastern Europe

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Summary

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Summary

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It is worth recalling the research questions posed by the authors: RQ1: Were tax and customs compliance instruments implemented in a way that facilitates or impedes compliance and trust between the tax system stakeholders? RQ2: Is their implementation in line with the proportionality principle? RQ3: Is there a coherent system of tax compliance tools about which it could be said that it provides universal assurance of the correctness of tax collection from the point of view of both the taxpayer and the tax authorities? RQ4: Do tax compliance instruments promote legal certainty and loyalty? RQ5: What are the main drawbacks of tax compliance tools? RQ6: Are there tools in the current tax and customs system whose operation produces results consistent with the objectives of tax compliance and, if so, what are the possibilities for their dissemination within the system? RQ7: What are the essential criteria that, if met, will ensure that the tools in question are effective in line with the objectives of tax compliance and at the same time comply with the fundamental principles of the rule of law?

Any action taken by public authorities should have a specific justification. It may be the protection of the values within which society functions or should function. It can also be rationalised by elements, primarily economic, relating to activities already deemed worth sustaining and developing. Some activities may also be rationalised by benefits accruing to the circles in power or groups supporting that power.

Tax compliance can be viewed and justified virtually at all the levels demonstrated above. As a goal and a way for the authorities to act, it is a mechanism that justifies the existence of modern civil society, based on conscious interaction aimed at creating a modern, informed society. In this interaction, the most important factor is the law – the language with which the state communicates with the addressee of its authority – the citizen. This relationship, based on the principle of loyalty, requires that the governed submit to the rules set by those in power, but also that the latter perceive the welfare of the governed as the goal of statehood and therefore its authority. In this context, compliance becomes a complex instrument of a higher level than mere blind adherence to the law. This is because simple submission to the rules is mechanical in nature and does not presuppose the conscious participation of the governed in the creation of governance mechanisms. The compliance mechanism itself, as it is inferred in Chapter 1, presupposes the existence and

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functioning of mechanisms allowing for the participation of the addressee of regulations in the objectives of their implementation as well as through active participation in their creation, through consultation or co-determination mechanisms. These mechanisms are to be understood as a complex of formal institutions – state regulations that impose obligations on taxpayers to self-evaluate company processes for compliance, as well as corresponding tools within companies to ensure the correct performance of obligations. The pursuit of societal benefits will, in practice, occur in parallel with the maximisation of the benefits of groups in power and their support circles. Their welfare, as well as that of the environments on which power is based, must take into account the welfare of the addressees of power. For this reason, as Chapter 1 seeks to demonstrate, compliance institutions must be inherently interactive, involving cooperation between the governed and those in power. These activities, in view of the finite nature of the resources remaining under public management, should be achieved with the assumption of cost-effectiveness – maximisation of the effects obtained from the expenditures made.

The justifications for compliance raised above essentially come down to the implementation elements of the economic analysis of law. As fully conscious interactions of the parties to a legal relationship established between the governed and those in power, they must aim to seek to minimise the systemic costs, seen as transaction costs, associated with achieving the state of the rule of law (understood as the realisation of the state of loyal performance of a public contract), they must focus on reducing the social costs associated with any lack thereof and the need to compensate for non-compliance with extensive coercion and sanctions. This means, as Chapter 2 tries to show, that any compliance mechanism will emphasise the economic benefits of its existence both on the side of the taxpayer (lower costs, self-regulated processing, risk management) and on the side of the administration (operating costs, budget revenues, etc.). The threshold for the social effectiveness of compliance processes will therefore be a situation in which the sum of the social costs of compliance will be lower than the sum of the alternative economic costs of the risk resulting from the absence of the relevant instruments and the need to mitigate them.

The conditions outlined above allow us to adopt as a kind of goal for the legislator the creation of a certain compliance system with a capacity to develop, resistant to the temptation of abuse from both sides of the legal relationship. Resistant, therefore, to abuse on the part of the addressees – leading to the absence of abuse in the form of radical tax optimisation that is difficult to distinguish from tax evasion, and on the part of the tax authorities, leading to the reduction of tax uncertainty, arbitrariness and self-interest. Chapter 2 tries to show that all of the above observations lead to the need to rely on an assumption fundamental to the essence of the phenomenon, that is, securing loyalty conditions for its operation. At the same time, this leads to the need to rely on a slightly different, more comprehensive concept of compliance that emphasises not so much explicit institutions with permanent content and shape, but the concept of solutions that are directional markers of a process with a fixed goal but constantly evolving means of achieving it. The activity of the public authority in this context is an initiating mechanism, inducing

cooperation on the part of taxpayers interested in compliance. The activity of the authority may be based primarily on formal activities (related to lawmaking and application of the law), but also on informational and educational elements, which do not have to be mandatory but compliance with them is an expression of willingness to cooperate on the part of the taxpayer, facilitating cooperation and, as a result, constituting a kind of pledge of trust. This phenomenon, in effect, does not imply a differentiation of taxpayers assuming elements of discrimination but is the basis for a legitimate differentiation in the treatment of groups of taxpayers that are ready to deepen cooperation and not fully prepared to do so, and therefore also treated in a somewhat more scrupulous manner.

Compliance, therefore, becomes an element in the upbringing of civil society within which, with full respect for the dissimilarities of specific entities, the authority seeks to achieve cooperation between the tax administration and taxpayers. A necessary element within its framework becomes the assumption of the necessity of adjusting incentives to the conditions of constantly changing reality, the development of the environment and the market, as well as the necessity of responding to the mechanisms of gradual indifference of the addressees of the law to incentives, a feature that must be taken into account in any attempt to educate by law.

As a result, compliance must become a continuous, planned process, assuming the sustainability not of formal institutions but of adjustments aimed at achieving the goal of consensual cooperation. These adjustments will include activities of a formal and informal nature undertaken in parallel by public and private entities. Relatively the most promising matter in this regard will be procedural mechanisms within which access to reliable information from taxpayers and loyal listening to the positions of taxpayers – parties to the operation of the compliance process – will be crucial. This is not possible without a sense and implementation of mutual loyalty based on the concept of the rule of law discussed in Chapter 2. In line with these observations are those made in Chapter 4, according to which procedural institutions are the essential guarantee of legalism and democracy.

The conclusions presented above are of a fundamental nature. It is possible, based on them, to evaluate the introduced and existing solutions without losing sight of the specifics of these solutions and the assumed goals, which necessarily have to be of a preliminary nature – determined by the needs and assumptions of the Polish and other tax systems and the requirements introduced by EU law.

For this reason, observing the introduction and development of compliance institutions must take into account as a necessary element the strong negative reactions associated with their introduction. The lack of social trust (low social capital) in the new member states, significant social acquiescence to tax abuse and the lack of a coherent concept of tax policy, which has been perpetuated for decades, all have an impact on the considerable caution of those who govern and those who are governed towards compliance institutions. However, regardless of the evaluations formulated, it should be emphasised that all attempts to introduce compliance solutions have a very positive character – making room for habits, developing mechanisms of openness and cooperation and thus also creating the foundations of civil society in its most direct dimension, which is monetary relations. Once

implemented, they will create room for improvement, which anyway, as demonstrated above, must be in the nature of a process and a constantly evolving procedure (see RQ1).

The above confirms that tax compliance has considerable potential, which may foster an effective and efficient target model of cooperation between taxpayers and tax authorities. The tax compliance model implemented by the taxpayer should also entail changes in tax procedures on the part of the state. In this respect, the change should involve the replacement of the classic model of administrative proceedings, having the features of authoritative proceedings based on the inquisitorial model, with an uncontested model, based on dialogue, trust and cooperation. Such opportunities are provided by tax compliance. Taxpayers who submit to self-regulation and introduce the tax compliance model should also meet with appropriate consideration of these circumstances by generally applicable regulations.

However, our research shows that taxpayers are subject to a number of tax compliance obligations. At the same time, the classic model of cooperation between taxpayers and tax authorities is maintained. In most of the areas examined (among others, in the field of the GAAR, which results from Chapter 5, withholding tax – Chapter 6, VAT – Chapter 7, DAC6 – Chapter 8, transfer pricing Chapters 9 and 11), a large number of regulatory initiatives were recorded resulting in more tax obligations. Regulations are conducive to uncertainty and in order to reduce this uncertainty, actions are taken at the enterprise level to self-regulate, implement the highest standards, and implement management systems (also based on the ISO 37301 standards). However, taxpayers are not prepared to implement compliance regulations, and frequent legislative changes and the introduction of new solutions are not conducive to this. In fact, as it results from the examination of relevant procedures (e.g. from DAC6, which results from Chapter 8), taxpayers, despite the obligation, do not apply appropriate regulations (see RQ2).

Compliance in fact increases operating costs, and the regulations and obligations adopted do not take into account the size, specificity and potential of the taxpayer. The example of Poland shows that the aforementioned DAC6 instrument is an obligation extended at the expense of taxpayers, and the surveyed taxpayers note that the collection of data and information can be carried out using other available knowledge bases (see RQ2).

According to the research carried out, in practice, there is no coherent system of tax compliance tools about which it could be said that it provides universal assurance of the correctness of tax collection from the point of view of both the taxpayer and the tax authorities. From the point of view of the tax authorities, despite the fact that the national legislators tend to impose increased requirements, the tax authorities have insufficient knowledge and tools to use the data generated via the tools in question for the purpose of combating tax avoidance and tax evasion efficiently. Multiple jurisdictions do not have the capacity to use the obtained data efficiently, implement excessive requirements for domestic taxpayers and repeat demands for the same or similar submissions with modalities to multinational groups operating in multiple jurisdictions (Chapter 3).

On the other hand, from the perspective of the taxpayer, the various tax compliance instruments are characterised by significant shortcomings in this respect, including:

- limited scope of action (e.g. in relation to a narrow group of large taxpayers);
- the lack of a "protective effect" on the taxpayer (tax remitter) despite the fulfilment of the obligations imposed on it and
- the undefined nature of the obligations imposed on taxpayers (tax remitters), resulting in uncertainty as to whether these obligations have been duly fulfilled (see RQ2, RQ3 and RQ5).

In principle, the GAAR (Chapter 5) does not provide universally available tools to allow the taxpayer to have a reasonable belief that its transactions will not be challenged as tax avoidance in the future. Some comfort in this respect may be provided by horizontal cooperation, which, however, is addressed to a small number of entities recruited from among the largest taxpayers (Chapter 10) and, in the Polish reality, by obtaining an advance ruling (protective opinion), which, however, can hardly be called a generally available tool due to administrative barriers. In the case of the GAAR, however, it is difficult to expect that the legislator will be ready to introduce tools leading to the elimination of the risk of its application, due to the function of the GAAR. By its very nature, it is intended to protect against atypical tax avoidance schemes (the tools against typical schemes, identified earlier, take the form of special provisions, introduced successively after more schemes become widespread). One could imagine that taxpayers' diligent compliance with MDR and other types of reporting obligations under BEPS (Chapters 8 and 11) should protect them from the risk of the GAAR being applied to them. Indeed, the purpose of the introduction of MDR comes down to the tax authorities gaining knowledge, based on proper reporting by taxpayers, of schemes that could potentially be used in tax avoidance. However, it is in vain to look for mechanisms in the legislation of individual countries that would "promote" taxpayers that maintain MDR compliance with any protection against the application of the GAAR. The MDR obligation is "one-sided": the taxpayer's reporting obligation is not accompanied by any feedback from the tax authorities from which the taxpayer could infer whether the tax schemes it reports will or could be challenged by the tax authorities. Such an MDR model is not conducive to building mutual trust between the taxpayer and the tax authorities, and compliance with the MDR obligation may be perceived by taxpayers as a source of additional tax risk of discovering tax avoidance which would not have been detected had it not been subject to the MDR. Besides, the introduction of a feedback mechanism, even if there were such a legislative plan, is hindered by the difficulty of defining the material scope of MDR reporting. The imprecision of the MDR reporting provisions, pointed out in the research, already in itself creates uncertainty as to whether the taxpayer has complied with the reporting obligation, which would consequently undermine the value of any feedback (see RQ4).

The WHT (Chapter 6) in its basic model (with the exception of the TRACE regime, which deserves separate conclusions below) imposes a duty on the tax

remitter (and indirectly also on the taxpayer) to exercise due diligence in determining whether the use of an exemption or reduced tax rate is abusive, i.e. whether the structure of the related companies between which the WHT payment occurs was created for legitimate economic reasons or mainly to avoid taxation. There is no checklist that allows the tax remitter to believe that he has exercised due diligence; this criterion remains undefined. Some jurisdictions provide for the possibility of obtaining a prior opinion from the tax authority as to whether a planned payment of a receivable may be subject to an exemption or reduced rate, or the need to pay WHT first in order to then be able to claim a refund (during the refund procedure, the tax authority verifies that the exemption would not be abusive). These solutions are potentially effective tax compliance tools except that the second one (tax refund) is, from a liquidity point of view, a completely different solution than the exemption itself (see RQ6).

In the field of VAT (Chapter 7), the focus is on the proliferation and increasing sophistication of the digitalisation of the documentation, recording and reporting of turnover and tax, not only for digital products, but generally for the entire turnover of goods and services. The taxpayer can identify quite precisely what its recording and reporting obligations are and, therefore, the sense of certainty of compliance in this respect is relatively high. The jurisdictions examined also allow the taxpayer to obtain a binding interpretation as to the correctness of its VAT rate or exemption. By contrast, both the abuse of law doctrine (Halifax) and the principle of denial of the right to deduct input VAT in the event of a taxpayer's failure to exercise due diligence to eliminate participation in a VAT-criminal transaction chain (Kittel doctrine) continue to apply in VAT. The abuse of law doctrine is the functional equivalent of the GAAR and for this reason, as with the GAAR, it is difficult to expect that tax compliance tools will exist to eliminate the risk of application of the abuse of law doctrine. As far as the Kittel doctrine is concerned, one can venture a guess that, with the improvement of the record-keeping and reporting tools, it will take on the role of a "weapon of last resort" against exceptional cases of gross negligence of taxpayers (see RQ6).

The transfer pricing compliance obligations (Chapters 9 and 11), manifested, among others, in the need for extensive and multi-step reporting, according to the research, are by no means eliminating the risk of transfer pricing challenges and are at the same time characterised as inadequate and disproportionate in relation to the objective of counteracting tax base erosion and profit shifting. In terms of TP, APA and MAP procedures could potentially be an effective tool to ensure compliance. However, studies indicate that they are currently ineffective (see RQ1, RQ2, RQ4).

Noteworthy are the cases identified during the research where professional, licensed (credible to the tax authorities) entities involved in tax settlements have been introduced into the system. These include the AEO for customs (Chapter 12) and the financial intermediary for WHT in the Finnish TRACE system (Chapter 6). The participation of such an entity in the tax settlement ensures the professionalisation of tax compliance processes (this is, after all, the purpose and essence of the functioning of such entities), which results in their greater fiscal efficiency (real possibility of detecting possible abuse, resulting from know-how, knowledge of the

market and recognition of abuse patterns). Such a solution obviously increases the costs of tax collection, but it should be borne in mind that some of the compliance obligations currently incumbent on "ordinary" taxpayers also generate significant collection costs, albeit hidden among other ongoing management costs. On the other hand, the real disadvantage of such a solution may turn out to be a de facto restriction of the freedom of establishment for taxpayers who, for whatever reason (usually due to too small a scale of activity), cannot join the system themselves (see RQ6).

It is necessary from this point of view to formulate a general view of the compliance elements introduced in the countries of Central and Eastern Europe, which in general must be evaluated as only relatively effective and aimed not at taxpayers in general, but rather at selected groups of them, and through punctual rather than comprehensive institutions, having, as shown in Chapter 10, only a pro-fiscal character (see RQ1).

Elements of tax compliance are not universal in nature. Exclusivity refers primarily to their targeting of entities that are large and often prone to the temptation of abuse, which leads one to believe that they result in elements of reverse discrimination, albeit consistent with EU law, but resulting in an erosion of the sense of equality and loyalty of taxation.

The considerations and findings of the research make it possible to formulate postulates regarding the desired perception of the compliance process, noticeably going beyond the definition ascribed to it so far. The proposed understanding of the concept should, in our opinion, take into account the three structural elements that are, respectively:

- trust of the parties to the relationship and loyalty in the performance of the relationship,
- the permanent and necessarily development-oriented nature of the relationship,
- the procedural nature of the interaction both externally (generally applicable law) and internally (internal taxpayer procedures).

In this context, compliance should be understood as an evolving system of tax-related institutions and procedures aimed at securing security and predictability in the sphere of tax payment in the right amount, place and time, which is part of tax risk management in the enterprise (see RQ7).

The concept of tax compliance understood in this way also includes IT tools and solutions for fulfilling tax obligations under generally applicable law.