

Introduction

1. Tax office and ministry of finance officials from 32 developing member countries participated in the 17th Tax Conference (the conference) to discuss the design and administration of income tax and value added tax (VAT) in the Asian-Pacific region. The conference, sponsored and organized by the Asian Development Bank (ADB), ADB Institute (ADBI), the Tax Bureau of the Ministry of Finance, Japan and the Organisation for Economic Cooperation and Development (OECD), was financed through the Japan Special Fund, a unique grant facility funded by the Government of Japan to the ADB. The co-ordinator of the conference was Mr. Teruo Ujiie, Senior Capacity Building Specialist, Capacity Building and Training Division, ADB Institute.

Opening Remarks

2. Delegates were welcomed to the conference by **Mr. Teruo Ujiie**. Two sets of brief introductory remarks followed.

3. The first introductory presentation was made by **Mr. Toshiya Ohtsu**, Director for International Issues on Taxation, Tax Bureau, Ministry of Finance of Japan. Mr. Ohtsu welcomed delegates to the conference.

4. Mr. Ohtsu observed that tax issues had changed notably in the period of almost two decades since the first tax conference organized by ADB in 1991. The conference has become one of the region's established tax events, with an evolving role over this period. These years have seen rapid changes in cross-border trade and investment and in investors' ability to route investments through alternative channels. Unilateral responses to new problems are proving increasingly problematic and it is becoming increasingly clearer that bilateral and multilateral solutions are needed. The conference plays an important role in fostering needed regional cooperation.

5. The second introductory presentation was made by **Mr. Masahiro Kawai**, Dean, ADB Institute. Mr. Kawai reported to delegates on the findings of the most recent periodic review of its tax conferences which indicated the conferences had contributed to improvement in the effectiveness of tax policies and the efficiency of tax administration in participating countries. There is, he noted, a direct link between optimal tax policies and maximizing the effectiveness of tax administrations and economic development and poverty reduction. Different tax systems can have different impacts on the speed of economic development and the distribution of income and wealth in society. For example, the effectiveness of new VAT systems to offset declines in customs duty revenues will depend on the design and implementation of the consumption taxes.

6. Mr. Kawai noted that the globalization and regionalization of economic activities had led to the emergence of new issues and challenges including the risks of greater international tax competition, tax evasion and avoidance stemming in part from exploitation of differences in bilateral tax treaties. In the absence of a global or regional forum of taxation, the tax conferences can play an important role in facilitating cooperation by regional tax administrators.

Keynote Address: Adapting Tax Systems to Economic & Social Development

7. The keynote address of the Conference was delivered by **Professor Frans Vanistendael**, Academic Chairman, International Bureau of Fiscal Documentation (IBFD), The Netherlands.

8. Tax systems need to be tailor-made. General prescriptions can be dangerous, as can models imposed by international institutions. Models from abroad are unlikely to reflect local conditions. That said, it is always very instructive to look across the border and see what lessons can be learned from neighboring jurisdictions. Also, international experience can offer some general rules.

9. In the context of a VAT, a fundamental principle is the desirability of single low rate applied to a broad base with no exemptions or concessions. A high initial registration threshold limits the costs of administration until capacity is developed. The key point to consider in terms of excise taxes is the need to have the taxes rise automatically in line with inflation if they are based on quantity rather than ad valorem.

10. There are a number of basic principles to consider with the company income tax. Alignment of the company tax rate and top individual rate will eliminate schemes to shift income from individuals to companies. All income of a company (including so-called "capital gains") should be taxed at the same rate. Long carry forward periods for losses should be used to reduce any bias against start up and riskier investments. Retained profits distributed upon liquidation or winding up should be treated as dividends to achieve neutrality between distributions immediately before and immediately after winding up.

11. Lessons learned in respect of personal income tax include the need to impose the tax on individuals and not some sort of family or marital unit. There is no need for a large number of rate bands. A large zero rate threshold can exclude most low income earners from the system. Withholding taxes can be used for many types of income. The so-called "double taxation of dividends" from taxing companies and company distributions is not really a serious problem; a low withholding tax on dividends can improve progressivity.

12. On a more general note, there are benefits to be realized if a general tax code is adopted to provide basic definitions for all taxes and a general anti-avoidance rule for all taxes. The law should establish a single taxpayer identification number for all taxes (and social security). It can also provide one or at least similar procedural rules for filing tax returns, tax protests, litigation, procedures, liens and payments. The law should provide for an adequate and fully independent administrative tax procedure of review before allowing the taxpayer to go to the ordinary court system. It should also provide for a clear distinction between the conditions that will attract administrative penalties and those which will attract criminal penalties. Administrative penalties are intended to keep the taxpayer in line. They should be moderate and be applied to both intentional and unintentional infringements of the tax rules. Criminal penalties should be used sparingly and only when the criminal intent of the taxpayer has been established beyond any doubt.

13. Clearly an effective tax administration is crucial to the success of a tax system. An effective tax administration is one that is independent, free of political interference, and adequately remunerated. Three broad models for structural

organization are found in different jurisdictions. The first is organized into different sections to deal with different types of taxes (e.g., a VAT section, an income tax section, etc.). The second is organized along functional lines (e.g., assessment, auditing, collection, etc.). The third is client based, with different sections of the administration charged with responsibility for servicing different types of taxpayers (e.g., large business units, wage earners, etc.). There are advantages and disadvantages to each of the models and the appropriate model for any given jurisdiction might change over time as the tax system and tax administration mature.

14. With economic development comes demographic change. As economic development proceeds, populations become more urban, the birth rate slows, and the population “ages.” It is possible for a society with a smaller aged population to fund the social needs of this group from current revenues and inputs from younger workers. This approach becomes less tenable as the population ages until the society reaches the point where it must ensure younger workers defer some consumption by saving so they can draw on those savings to support themselves in retirement. The question then arises what steps should be taken to divert some current consumption by workers to deferred consumption by shifting part of their incomes into retirement savings. While there is a debate as to whether compulsory rules (e.g., compulsory national or private pension contributions) or inducements to save are more efficient, most western jurisdictions have adopted some tax incentives to encourage retirement savings.

15. While compulsory savings schemes generally or at least for the public service are in effect in several Asian countries, most continue to rely on private savings to fund a substantial portion of retirement consumption. With current demographics, it is possible to introduce pensions in Asian countries funded entirely by current taxation of workers (known as a “pay as you go” system.) In the longer term, however, there must be reliance on private savings.

16. More developed countries originally relied on “defined benefits” schemes. These are based on contributions to a pension fund by employees and employers with the employer guaranteeing a certain pension level in the event of an economic downturn that reduced the resources available in the pension fund to a level which could not support the promised pension. Many countries have shifted from defined benefits schemes to defined contribution schemes where the retired person bears the entire risk of economic downturn and enjoys the benefit of a higher pension if investments have grown more than expected. The defined contributions scheme appears to be most viable in the longer term.

17. While there are many examples of different types of concessional tax regimes to encourage savings for retirement, the norm appears to be a tax preference for initial contributions and low or no taxation of accumulating funds, with taxes deferred until amounts are taken from the savings plan and received as a pension. The initial tax preference for contributions could take the form of a deduction for employee/self-employed contributions (or non-recognition of employer contributions) or a credit. The deduction or non-recognition has vertical equity implications as the concession is far more valuable for high income persons than for low income persons. A credit will provide equal benefits for each dollar (or equivalent) contributed.

18. Three design points were noted. First, because the preferential treatment of retirement savings plans can provide significant benefits, particularly to higher income persons who would save for retirement in any case, it is important that strict caps be imposed on the amount that can be contributed to a tax-preferred vehicle. Second, strict rules are needed to ensure the tax-preferred savings are retained in

the savings vehicle until retirement and not accessed before. Third, caution must be taken if employers are able to operate their own pension funds for employees. It is not desirable if some businesses can access tax-preferred funds for internal purposes. Also, this is unfair to the employees who lose the benefits of investment diversification.

Special Presentation I: VAT Design, Planning and Implementation: International Best Practices

19. Three special presentations were delivered to the conference. The first, by Mr. Satya Poddar, provided conference participants with a guide to international best practices in the design, planning and implementation of a VAT. Mr. Poddar is a Partner with Ernst & Young Pvt. Ltd., India and was formerly with the Canadian Department of Finance where he played a key role in the adoption of the Canadian goods and services tax (GST), the Canadian version of VAT.

20. VAT is one of the progressive changes that happened in the last five decades in the area of taxation worldwide. VAT today has been accepted in 130 countries around the world and accounts for 20% of the worldwide tax revenues. Mr. Poddar highlighted the contribution of the VAT to the world economy by noting that VAT revenues account for nearly 7.5% of GDP in the European Union while even the oil-rich Gulf Co-operation Council is considering implementation of VAT to augment its revenues.

21. From the standpoint of taxpayers, VAT is a relatively simple tax to comply with. Administrators have found VAT relatively easier to enforce. In addition, VAT does not require accrual accounting. For the governments and policy makers, VAT is attractive since it can be levied to virtually all sectors of the economy free from economic distortions. It is neutral to changes in trading and distribution and is also inflation neutral. Given that VAT could be applied to a broad base including goods, services, real property and intangibles, it has proven to be a “money machine” for governments keen on raising revenues in an “efficient, effective and equitable” manner.

22. In addition, a destination-based VAT is also immune to cross-border mobility of capital, labor and goods. A finer point of debate is often whether it is immune to cross-border mobility of services, too. The structure of VAT respects the fiscal autonomy of the individual national jurisdictions (and sub-national jurisdictions in the case of federal economies).

23. A unique feature of the VAT is the fact that so-called “exempt” supplies actually bear tax because the supplier is not able to recover any tax included in the price of its inputs. As a consequence, the tax discourages exemptions and it is immune to what Mr. Poddar labelled “tax termites” who undermine a tax base by seeking exemptions. As Mr. Poddar explained, under VAT, “the more you are exempted from tax, the more you become taxable” as exemption denies the right to claim input tax credit. Persons exempted under VAT are consumers and employees, who then become the main taxpayers.

24. Introduction of VAT is both a significant socio-political intervention as well as an economic policy measure. It poses significant challenges because of the complexity of development, demand for skilled and experienced human resources in design and implementation and its widespread impact on society and economy. This makes it essential to design, plan and implement VAT with care.

25. A good VAT design is distinguished by its three E's—Efficiency, Effectiveness and Equity – defined as follows:

- A VAT design is Efficient if it satisfies the condition of economic neutrality. A properly designed VAT is non-cascading since full, timely credit for taxes paid on current and capital inputs is provided, and is levied on the basis of the destination principle.
- A VAT is known to be Effective because it provides increased revenue yield with least cost to the state and facilitates voluntary compliance.
- A VAT is Equitable as it provides greater control of fraud and collusion, greater transparency in tax administration with limited discretion or discrimination.

26. The key design elements of VAT fall into two broad camps: policy elements and administrative elements. The base and rate form the crucial, initial set of questions to be answered in design of VAT. Historically, VAT models have included multiple and high standard rates. For example: the standard VAT rate in the European Union is around 20%. Some of the standard exemptions in this model included social and cultural services, health and education, public sector bodies such as public radio and television broadcasts and postal services, immovable property, financial services such as insurance, banking and security transactions and gambling.

27. Modern VAT models covering both goods and services (often referred to as GST) encompass single low rates as in Singapore (7%), New Zealand (12.5%) and Japan (5%). Further, exemptions are limited in modern VAT models. Exemptions are limited to a subset of financial services. Most supplies by public bodies and non-profit organizations are considered as taxable. Multiple rates or exemptions are no longer considered an efficient means of achieving progressive distribution of tax burden. Future innovations on VAT models can be in the direction of providing rebates to low-income households, as in Canada.

28. Historically, land and real property transactions were excluded from application of VAT. The modern approach includes all land and real property transactions under the tax umbrella, with the exception of used residential dwellings and long-term residential rentals.

29. Historically, supplies by government and public bodies, including basic education and health care were exempted from tax. Such bodies are often provided rebates of input taxes to minimize disincentives for outsourcing of services. Under the new models, public supplies are taxable on the consideration charged for them. In the case of free supplies, no tax is charged and full input tax refund is provided. As an example, countries such as New Zealand and Australia treat all activities of public sector as taxable.

30. Under the new models, the exemption for financial services is being limited to margin services, with explicit fees and general insurance made taxable. Provided below is a comparison of approaches followed by various nations in treating financial services for VAT.

31. Another key element of the policy decision is the setting of the right “threshold” for registration. A good balance between the administrative effort required and the marginal increase in tax revenues has to be maintained. A higher threshold could lead to competitive distortions. Some countries initially set higher thresholds and lowered the levels gradually e.g., Japan lowered it from 30m yen to 10m yen, Lebanon VAT was initially high and was lowered to \$100,000 in 2005.

32. An emerging policy and administrative issue in VAT is coping with the absence of fiscal borders in the European Union as well as in countries with sub-national VAT jurisdictions such as India. The solutions being tested include replacement of physical borders by audit mechanisms for books-of-accounts and inter-state harmonization and co-ordination systems. With respect to taxation of e-commerce it has been found that initial concerns were exaggerated and solution options include application of reverse charges or local registration of the foreign suppliers.

33. In determination of place of supply of international services to prevent double taxation and non-taxation, the OECD guidelines could prove useful. Tax frauds, especially with respect to refund claims, are a concern for VAT administrations. Carousel frauds are believed to have cost the United Kingdom (UK) treasury 1.1-1.9 billion Pounds in 2004-2005. Germany has estimated these to be to the tune of 2.1 billion Euros. In either context, while the frauds are significant, confidence is emerging among VAT administrations that it is manageable.

34. The initial administrative challenge confronted in the VAT is the issuance of registration. Registration initiates a taxpayers association with the VAT administration. Leading VAT administrations make significant efforts in ensuring that the taxpayer's details are up-to-date. The Tax Identification Number (TIN) provided to the taxpayer at the end of registration is a core element of the VAT administration's dealer database as it uniquely identifies a taxpayer. It is ideal to have a single TIN for a business for direct as well as indirect taxes. It is in this context that the need for single Business Identification Number (BIN) is often debated. In design of the TIN, three models exist—sequential, biographical and combination. Sequential models provide for a running serial number for newly registered taxpayers whereas biographical models consider personal information of the taxpayer in generation of the TIN.

35. VAT returns are a significant measure of compliance in VAT administrations. Therefore, facilities for electronic filing of VAT returns have been implemented as key administrative measures by leading VAT administrations to promote compliance. A key challenge often faced has been the poor uptake of the electronic channels by taxpayers. Various incentive schemes have been designed by VAT administrations to encourage e-filing. Some of these include faster refunds, reduced return data, free of cost software for return preparation, monetary incentives, longer filing periods and helpdesks for support. In an instance, the United States **Internal Revenue Service** mailed over 23 million postcards to taxpayers to promote its newly launched e-Filing system.

36. Leading VAT administrations have stopped cash dealings to the greatest possible extent. VAT payment systems are increasingly being integrated with the banking systems. Numerous alternative channels are also being provided to ease compliance. For example, Australia provides several payment options that include payment through banks, direct credit/debit, mail payments, cheque, money orders and payments through post office.

37. Refunds continue to be the "Achilles heel" of VAT administrations. The UK National Audit Office estimated its VAT revenue loss with relation to VAT refund frauds to be between £7.17– 10.25 billion. VAT administrations have adopted different ways to handle VAT refunds. For example, Netherlands, New Zealand and UK have set up separate central automated processing centers while Sweden, Hungary and Slovak republic process refunds as part of return processing units. Given the criticality of VAT refunds, advanced VAT administrations have installed

mechanisms for budgeting for refund claims and have also specified timelines for refunds to taxpayers.

38. Various mechanisms have been formulated to prevent frauds related to VAT refunds. The mechanisms include selective invoice matching as seen in the Sales Tax Automated Refund Regime initiative of Pakistan; large-scale cross checking of invoices as in the case of the Republic of Korea, People's Republic of China and the state of Gujarat in India; certification of claims by certified public accountants as practiced in Kenya; payment for large purchases through banks as implemented in France, Hungary, Turkey and Azerbaijan; and mandating VAT bank accounts as in the case of Bulgaria.

39. VAT envisages voluntary compliance and it is essential that non-compliance be treated in a prudent manner. Large and discretionary penalties often lead to collusion and lower compliance. In this context, it is important to lay down consistent premises for penalties. Effective penalties may include interest at market rates, supplementary time-based non-discretionary penalty at 5 to 10% and for more serious non-compliance, additional discretionary penalty of 25 – 50% of tax unpaid/underpaid. For serious fraud and gross negligence, additional monetary penalties and imprisonment could be invoked provided these are supported by documentary evidence of evasion.

40. Large taxpayers often cover 50-80% of the tax revenues in VAT administrations and therefore, it is critical for the administrative staff to fully understand their business. It is with this intent that leading VAT administrations have set up dedicated Large Taxpayer Units (LTU). Key examples include The Netherlands which employs nearly 2,150 staff (7% of total staff strength) and New Zealand which employs 240 staff (5.5% of total staff strength) to manage LTUs. Some of the key LTU services include dedicated inquiry services; account managers; special education programs; and electronic, integrated reporting of payment and return data.

41. Following a survey of VAT policy and administration issues, Mr. Poddar turned to the planning and implementation issues faced by jurisdictions adopting a VAT. The fulcrum of VAT implementation is the VAT Development Unit. A key initial issue to be addressed is the organization of the VAT administration, followed by questions on filling the various staff positions and training of the staff. Crucial to the success of a VAT is development of appropriate IT systems and client support. An ongoing system of genuine consultation with stakeholders is also vitally important.

Special Presentation II: Reforming Personal Income Taxation

42. The income tax focus of the initial special presentation was complemented by a second special presentation on “streamlining” the personal income tax by **Professor Kevin Holmes** of the School of Accounting and Commercial Law, Victoria University, Wellington, New Zealand. Professor Holmes used the term “streamlining” to signify simplifying the personal income tax system to facilitate increased taxpayer engagement.

43. The presentation addressed the question of increased taxpayer engagement from three perspectives: the fairness of the personal income tax system, the ease of understandability and acceptance of the tax law, and reduction of compliance costs imposed on taxpayers. Significantly, administration costs borne by the tax authority also can be reduced by streamlining the personal income tax system.

44. Fairness (or equity) requires, as far as practicable, the taxation of all benefits that are derived by a taxpayer, without differentiating between the nature of separate items of income. That means embracing benefits in kind, as well as cash income, into an individual's taxable income. It also means taxing all sources of a person's worldwide income in the same way.

45. If the personal income tax system is not only fair, but also perceived to be fair, a greater number of taxpayers will engage in the system and be more willing to comply with their obligations to pay tax. The key is for taxpayers to understand that they are treated equally with other taxpayers who are in similar circumstances, and see the benefits, in the form of public expenditure outcomes, which are financed by their tax payment contributions to the state. In the context of fairness, Professor Holmes illustrated why, from a tax equity perspective, tax rebates are superior to tax exemptions where a progressive income tax rate scale operates.

46. The key to taxpayer engagement with the personal income tax system is simplicity. That means that the personal income tax legislation must be comprehensible to the lay person. (A greater degree of complexity might be justified in the corporate income tax law, where the players are more sophisticated and the transactions are more intricate or convoluted). To achieve comprehensibility, the personal income tax legislation must be understandable, uncomplicated, logical, and linguistically simple. As well as facilitating increased tax payer engagement generally, simple legislation reduces the opportunities for tax evasion, tax avoidance, and corruption.

47. Taxpayer self-assessment of tax requires taxpayers themselves to calculate and pay their tax liabilities. The accuracy of their calculations is periodically checked by the tax administration and, to the extent that there are deficiencies in the taxpayer's workings, the discovered shortfall in tax remitted, together with (deterrent) penalties, becomes payable. This approach places the compliance onus and costs onto the taxpayer, and correspondingly allows cost savings to the tax administration, which can focus its resources on the audit of (typically, larger corporate) taxpayers, rather than on the processing of tax returns and assessment of taxpayers.

48. A closer alignment of the accounting measure of net income with the taxable income measure may allow for a reduction in business taxpayer tax compliance costs (and may well capture a broader range of income). Tax auditing can then concentrate on the disparities between the accounting net profit figure and the amount of taxable income.

49. A critical factor in reducing tax administration and taxpayer compliance costs is to remove the compliance obligations from as many taxpayers as possible. Final withholding taxes empower this objective by removing salary and wage earners and earners of passive income (other than capital gains) such as interest and dividends from the requirements to file tax returns and make tax payments. This approach works particularly well where the individual income tax rate is a flat rate, rather than a progressive scale and there are no (or few) exemptions, deductions and rebates. It can operate when these factors are present, but is more vulnerable to error and abuse. Thus, the effectiveness of the final withholding tax mechanism requires a trade-off between the (possible) objective of vertical equity (embodied in a progressive tax rate scale) and minimization of taxpayer compliance and tax administrative costs.

50. The compliance and audit focus of the final withholding tax regime falls upon the payers of the income, not the recipients. Overall, compliance and tax

administration costs are reduced significantly because there are far fewer payers of income than there are payees. For the same reason, the tax administration's audit spotlight shines on employers and payers of passive income, rather than the multitude of employees and investors.

51. Regular payments of withholding taxes deducted at source provides the means for a regular cash inflow of tax to the government and enables automatic reconciliations of tax paid on behalf of, with tax payable by, the taxpayer via maintenance of an individual account with the tax administration for each taxpayer. Ultimately, the tax administration can calculate unilaterally each taxpayer's annual tax liability based on the information provided to it. That information accompanies periodic withholding payments from the income paid to the taxpayer, which are made to the tax administration. The taxpayer's income tax liability calculated by the tax administration is reconciled with the amount of tax actually received in relation to the particular taxpayer. To the extent that there is a deficiency, corrective measures can be pursued with the payer of the income (and the relevant penalties imposed); if there is a surplus, a refund of the excess tax paid on behalf of the taxpayer can be automatically and expeditiously refunded.

52. This approach removes the need for most people to participate in the compliance aspect of the personal income tax system. Only if an individual derives business income or income that is not subject to a final withholding tax such as a capital gain is an annual return of income required from the taxpayer. Such a streamlined final withholding tax regime yields economic efficiencies, which nowadays most governments covet. However, it requires sufficient investment in an IT system, which can record and monitor individuals' tax positions on an ongoing basis.

53. Other measures that a tax administration must implement to generate a high(er) level of engagement of individual taxpayers (particularly, but not exclusively, business individuals) include ensuring taxpayers have easy access to information and assistance services through resources such as call centres and counter enquiry centres, internet downloadable forms, provision of a range of tax payment options, use of taxpayer education campaigns, promoting the use of accountable tax agents, and upgrading tax administration staff training.

Recent Developments in Japan's International Taxation

54. A survey of recent developments in Japan's international tax rules and procedures was presented by **Mr. Kentaro Ogata**, First Deputy Director, International Tax Policy Division, Tax Bureau, Ministry of Finance, Japan. Mr. Ogata introduced the subject by noting how in the closing decades of the 20th century, Japan responded to the first stages of globalization by adopting international tax rules now commonly found in taxation laws including thin capitalization rules and transfer pricing rules. These rules have been refined and their operation modernized as the pace of globalization increased. One consequence has been a significant rise in re-assessments following transfer pricing disputes. The number of transfer pricing disputes has trebled over the past five years.

55. The application of transfer pricing rules has emerged as the focus of recent administrative reforms, particularly the use of advance pricing agreements (APAs) between taxpayers and the tax authority setting an acceptable price for related party transactions before the transactions actually take place and mutual agreement procedures (MAPs) which bring together taxpayers and tax authorities in Japan and a treaty partner to set a single transfer price that will be accepted in both jurisdictions.

56. Mr. Ogata's presentation focused on very recent (2007) transfer pricing measures. Three issues were highlighted. The first of these was the adoption of a rule which suspends the payment of disputed tax during the MAP process. This change provides a cash flow benefit to taxpayers. Generally, it takes about two years to reach a MAP resolution. If a MAP agreement cannot be reached within five years, the National Tax Authority (NTA) will declare the application closed so tax becomes payable.

57. The second development was the issuance of administrative guidelines by the NTA explaining how the transfer pricing calculation methods will be applied to transactions involving intangibles and the provision of services. The NTA guidelines include an annex with 26 case studies that illustrate different aspects of the arms length pricing (ALP) process. Nine cases explain which ALP method will be used in which circumstances. Fifteen cases highlight points that must be noted when ALP calculations are made and two cases illustrate aspects of APA procedures.

58. Mr. Ogata provided details of selected cases drawn from the annex. The examples chosen showed when the NTA would apply the residual split method for calculating a transfer price, how the profit to be split would be calculated, and the split factors used to split residual profit. A further case study looked at an intra-group provision of services situation.

59. The last section of Mr. Ogata's presentation looked at the operation of APAs. APAs were first used in Japan in 1987. In the last half dozen years the number of requests for APAs has grown almost three-fold and a very large backlog of unresolved requests grew. To address the backlog and shorten the waiting time, the NTA has increased the number of persons assigned to APAs (there are now more than four times as many persons working on APAs as there were six years ago) and strengthened pre-filing consultation.

Development of the Tax Audit Framework of Hong Kong, China

60. The starting point for an effective audit strategy, argued **Mr. Kwok-kit Chiu**, Assistant Commissioner, Field Audit & Investigation, Inland Revenue Department, Hong Kong, China, is to recognize the limits of what can be achieved. As it is not cost effective to check each return filed, the integrity of the tax system will depend on the tax audit function which will in turn depend on effective identification of audit targets.

61. The authority to conduct an audit in Hong Kong, China derives from the Commissioner of Inland Revenue's power to determine the assessable profits of taxpayers. The audit function continuously evolved over the past 50 years, with the Hong Kong Inland Revenue drawing on the experiences of the UK and Australian tax authorities as well as that of the OECD.

62. The audit process starts with an automated screening of tax returns to select cases for post-assessment audit. The process uses a computerized system developed by the Hong Kong Inland Revenue known as the Assess First Audit Later System (AFAL) to assess returns and identify audit targets on the basis of pre-set criteria. Cases selected for further investigation are allotted to an assessing officer to conduct a "desk audit", a field auditor to conduct a "field audit" or an investigating officer to conduct an "in-depth investigation". The AFAL system facilitates the identification of potential high yield tax avoidance and evasion cases and provides an effective means of measuring tax compliance and ultimately promoting voluntary

compliance. On the strategic level, the AFAL system enables the redeployment of more resources to the tax audit function.

63. Crucial to the success of an audit program is the grant to the tax authority of sufficient information collection powers. But these powers must be used responsibly. The tax audit function should never go beyond its original mandate and it is essential for tax audits to be backed up by clear and transparent policy and procedures.

64. Modern audit techniques rely heavily on information technology and an important step in modernization of the audit function was equipping tax administrations with computers (mainframes, midranges, desk tops or laptops), processing software such as Excel and Word, audit and forensic software such as Idea and EnCase, as well as internal and external databases to allow faster responses, deeper analysis and a broader scope of work.

65. Information technologies have enabled tax administrations to redeploy resources. Technology might not have revolutionised tax audits and the future does not necessarily require a radical departure from traditional methods. It is the failure to master the complex demands of many facets of tax administration that has caused the erosion of a tax base. Inherent limitations of information technologies in the tax audit function are often neglected.

66. Possession of information is vital to successful tax audit operations. Tax information gathering capabilities can only be built up through continuous practice. Routine processing of tax returns and making written standard enquiries cannot cure the information asymmetry. Field work in a modern tax audit function appears unavoidable.

67. Tax audits can provide extended reconnaissance, protect against erosion of tax base, disrupt evasion activities and take out difficult targets. It alone however does not guarantee the integrity of the tax system. Tax audits must be coordinated with other functions (e.g., information technology, prosecution, legislation) to produce maximum strategic results.

68. Tax audit has further extended the traditional tax administration to include non-fiscal issues (e.g., money laundering, anti-terrorist financing etc.) The extensions demand resources, training and closer partnerships with other law enforcement agencies.

69. Audit capability must not be constrained and tax auditors should be trained to handle various types of industries, tax avoidance schemes and technical issues. Tax auditors should be trained to take out difficult targets through vigorous legal proceedings.

70. Tax audits are expensive and setting resource priorities correctly influences the results and likeliness of success. The setting of operational targets is only meaningful when the tax audit function has matured with tax auditors possessing a high degree of operational efficiency. Tax audit tactics require time to refine. They involve extensive experimentation, which often results in failure. Their development also demands a culture that allows innovation and debate unfettered by dogma. The driving force is rarely technology and improvements take place almost exclusively at the operational level.

71. Tax audits comprise a very demanding style of control system. Attempts should be made to address pressing issues arising from defects in organizational cultures. Key issues concern the design of a refined monitoring and control system.

72. Technology alone has rarely driven changes but it can be a catalyst. Tax audits are not simply about technology. Tax audits are about concepts and doctrines that utilize technology to achieve larger purposes. Changes in tax audits have emerged from evolutionary problem solving directed at specific operational or tactical targets. Advancement in tax audits requires a coherent framework of doctrines and concepts built on realistic work cultures.

Special Presentation III: How to Administer VAT in a Borderless World of Global Trade: Lessons for Asia-Pacific States

73. The world in which modern VAT systems operate is far different than the one in which it was originally designed to operate half a century ago. **Mr. Christophe Grandcolas**, Tax Administration Modernization Consultant; Conservateur des Hypothèques, French Tax Administration, Paris, France explained some of the key differences as an introduction to his presentation on effective administration of a VAT today. Most supplies were tangible goods and border checks could be used as the basis for administering a destination-basis VAT.

74. Since 1993, border controls have disappeared in the European Union. More and more businesses are not established in the country of consumption and e-business grows at an accelerating rate. The elimination of border controls has presented significant challenges to VAT administrators. The experience of European administrators in adjusting to this new world may provide some useful lessons to Asian-Pacific countries that have joined regional trade blocks and those with sub-national level VATs.

75. The basis of the European response to the elimination of borders is the adoption of different systems for business to business (B2B) and business to consumer (B2C) transactions. In the case of B2B transactions, the supplier is relieved of liability to remit VAT and the customer is required to account for the VAT using a "reverse charge mechanism." This effectively suspends payment of the tax for most customers as the customer will account for the tax and claim an offsetting credit on the same return (unless the customer makes exempt supplies). In the case of B2C transactions, the supplier must register in the jurisdiction of the consumer and account for VAT in that jurisdiction. In theory, therefore, a supplier with customers across the European Union (EU) must register in 27 different jurisdictions. Registration procedures, return filing, and payment processes vary from country to country, imposing higher compliance costs on suppliers. The lack of cross-border audits appears to facilitate abuse and VAT losses due to fraud growing at a rapid rate.

76. The EU sought to address the problems raised by the new system through the use of an electronic database accessible by all jurisdictions which holds details of all registrations of suppliers with no establishment in the jurisdiction, as well as their reported supplies. However, the database has proved to be of limited benefit since there are no means to match data where taxpayers have different TINs in each jurisdiction. Moreover, mutual assistance procedures have proven so cumbersome they rarely yield useful information in usable time frames.

77. Further administrative measures have been proposed to deal with the problem but authorities have conceded the limitations of any administrative response. As a result, attention has shifted to more fundamental responses including proposals to shift from a destination-basis VAT to an origin-basis tax imposed where the supplier is rather than where the customer is located. Another proposal is to extend the reverse charge system to domestic B2B supplies but it appears this proposal will not be approved. A more likely response is the eventual establishment of a “one-stop” registration system in which a trader could register in a single jurisdiction and use the same TIN across the EU.

78. Drawing from European difficulties, one could conclude that the ideal approach for federal systems or trade communities would be adoption of a single law across all jurisdictions (one VAT rate, with a minimum number of and similar exemptions), adoption of the origin principle for interstate transactions, establishment of a simple clearance mechanism to channel the revenue to the states of consumption, and use of a single tax administration to manage and audit the VAT.

79. If the theoretical ideal cannot be adopted, a second best solution would be to retain different VAT laws in each jurisdiction but establish a single tax administration or at least establish a multi-jurisdiction VAT audit unit for cross-border transactions. In both cases, a common set of procedures and penalties should be implemented through a common revenue administration law.

The Relationship Between Accounting and Tax Principles

80. **Professor Richard Krever**, Department of Business Law and Taxation, Monash University, Australia, introduced a presentation on the relationship between accounting principles and tax principles with an explanation of the two broad design models used for business income tax laws. While it is extremely rare for countries to explicitly use accounting principles as the basis for measuring taxable income, in practice the tax administrations in most jurisdictions allow companies to use financial statements as the starting point for calculating their taxable income, with adjustments to take account for all the deviations between accounting principles and tax law.

81. Professor Krever identified five reasons why governments have not adopted international financial reporting standards as the basis for measuring taxable income. To begin with, no government has been willing to transfer what is considered a fundamental attribute of sovereignty, the power to determine a tax base, to a foreign external body with no accountability to the state. A related concern is the transfer of power to make ongoing changes to the base without consulting the national government. Another concern is the lack of certainty in accounting standards (the standards allow leeway in the sense of alternative treatments in many instances). Most importantly, governments often use income tax laws to achieve a variety of social, political and economic objectives outside the measurement of net gains over the past year.

82. Apart from the differences attributable to the government’s use of tax laws to achieve non-tax objectives, there are a range of differences that follow from the different objectives of accounting and tax. The target audience for financial accounts are creditors, current owners and potential investors. To protect the interests of these parties, accounting standards project look forward and seek to capture any current developments that might impair future earnings or lead to future obligations. Tax law measures net economic performance in a fixed period and tends to focus on each period separately. Thus, financial accounting will recognize in a current year

obligations such as future warranty obligations or accrued employee leave entitlements while tax law will not recognize these expenses until they actually crystallize.

83. Professor Kreyer classified legislative use of tax law to achieve non-tax objectives into six categories. The first was the use of tax law to address the problem of negative externalities—to correct the failure of market pricing to account for the true social costs of some goods or services. The second, and perhaps most important, group of deviations between tax law and accounting standards derived from the use of tax laws to subsidize goods or services that were thought to embody positive externalities—that is, to bring social benefits that might not be reflected in market pricing. For example, a government might provide tax subsidies for the consumption of certain types of goods or services it thought to be socially beneficial.

84. The second category also includes a range of instances where the government attempts to “second guess” the market by using subsidies to direct investment towards certain types of industries, regions, or types of production. Techniques include concessions, holidays, and accelerated depreciation. A third category comprises measures adopted to correct perceived market failure. The government may try to influence the market not because it thinks it knows better than the market but because it believes the market is not operating optimally for external reasons such as information asymmetry or the presence of natural monopolies.

85. A fourth area of difference arises from the government’s use of tax law to discourage particular types of behavior, particularly illegal or anti-social behavior, by increasing the cost of that behavior through denial of deductions for some types of expenses. Examples include prohibitions on the deduction of bribes or fines or expenses incurred to derive illegal profits. A fifth cause of divergence between financial accounting reports and tax law is the (often misguided) attempt by legislatures to “simplify” tax law through the adoption of rules such as pooling rules for depreciable assets or parallel accounting systems for small businesses.

86. Finally, tax law contains a wide range of integrity measures that require taxpayers to restate transactions for tax purposes where the government believes the transactions may have been adopted in part with the purpose of avoiding tax. These rules recharacterize transactions that would be accepted at face value for most financial reporting purposes. The first category of integrity rules are the transfer pricing rules that allow the revenue authority to restate the value of transactions between related parties. Many countries have international transfer pricing rules and parallel rules to deal with transactions between related persons such as family members within the jurisdiction.

87. A second group of integrity rules deviate from accounting standards by quarantining particular types of expenses against related gains—commonly found measures include rules that restrict the deductibility of capital losses to capital gains, interest expenses to investment income, foreign expenses to foreign-source income, and so forth. Another group of integrity rules recharacterize transactions where the tax law provides different treatments for similar payments. Examples in this group include thin capitalization rules which recharacterize interest expenses as the equivalent of profit distributions and “debt dividend” rules that recharacterize certain inter-corporate dividends as interest. Yet another group of rules deviates from accounting standards to effect surrogate taxation where direct taxation may be problematic. For example, many countries deny employers deductions for certain expenses incurred to provide benefits to employees as it thought that taxation at the employer level is simpler than taxing the benefits at the employee level.

88. Finally, one of the most significant departures between accounting principles and tax law is the inclusion in many countries' tax laws of specific and general anti-avoidance measures that allow the revenue authority to reconstruct tax-motivated transactions.

89. Professor Krever concluded by suggesting that the deviations between accounting principles and tax law offered opportunities for tax reform and refinement of tax legislation. This could be accomplished if governments noted all the instances where their tax laws deviated from accounting principles and identified the purpose of the deviation. This process could open the door to better targeting of measures intended to achieve particular non-tax objectives.

Recent Developments in International Tax Work at the OECD

90. The presentation by **Mr. Richard Parry**, Head of Unit for Co-operation with Non-OECD Economies, Centre for Tax Policy and Administration, OECD, commenced with a review of the nature and structure of the OECD and its Committee on Fiscal Affairs. The presentation emphasized the consensus approach followed by the OECD with respect to the production of instruments and guidelines before turning to some of the key developments in the OECD's tax program of work in 2007-2008.

91. The session focused on international tax issues and took as its starting point the changing global business environment including the domination of globally integrated businesses, the strengthening of the role of services economy and increasing significance of intangibles and rapidly changing business models. This reality lies behind much of the recent OECD work on the taxation of multinationals primarily carried on by the Committee on Fiscal Affairs' Working Party 6 in the areas of attribution of profits to permanent establishments, comparability, profit methods and business restructuring. The basic principles of the authorized OECD approach to profit attribution were illustrated and it was noted that whereas the work on profit attribution was almost complete, work in the other three areas was still in its early stages and that input from non-OECD economies and business would be welcomed.

92. The new business model tended to be based on regional rather than country structures and involved the centralization of risks and functions shifting the profit making elements to a central hub or, in the case of intangibles, to low tax territories. But there were good commercial reasons for restructurings and these should not be seen as simply tax driven, they harnessed new technology, streamlined management systems and the economies of scale to produce a more competitive product. OECD work focused on achieving a balance between certainty and transparency of treatment for restructures and ensuring that the relevant amount of tax was paid.

93. The presentation then considered recent treaty developments and reported progress on the ongoing work on non-discrimination. A major area of discussion was the OECD's work on resolving international tax disputes and this encouraged considerable discussion. The use of arbitration as a final guardian of tax payer rights to MAP determination in cases where countries agreed to its implementation was mentioned along with the work done to clarify and extend guidance in this area through the development of a manual for officials involved in the MAP. The nature of model treaty amendments and differing impact of changes to the commentary (which have effect immediately in respect of the relevant articles) and the articles themselves was explained. The new online Treaty Manual was also discussed and it was explained how it was a mix of both policy and administration issues which would

have benefits not only for treaty negotiators but also for those responsible for implementing the treaty in the course of their international audit work and tax officials were invited to use this as well as the electronic discussion group which was forthcoming.

94. The discussion then turned to the question of exchange of information, and the manual on Implementation of Assistance in Tax Collection based on Article 27 and the joint Council of Europe/OECD Convention on Mutual Assistance in Tax Matters. On Exchange of information, steady progress was reported on the incorporation of new Article 26 in new treaties and the role of Tax Information Exchange Agreements as providing the basis for future transparency and exchange of information.

95. Finally the work of the Forum on Tax Administration, and in particular the project on tax intermediaries was discussed. The question arose as to why and in what areas tax intermediaries should co-operate with tax authorities and it was indicated that the search for certainty in areas of complexity such as international taxation and the growing importance of corporate social responsibility in the wake of the Enron and Worldcom debacles meant that there was a platform for a new relationship between administrations and intermediaries. How this will develop in practice will be seen when the OECD publishes a report on this issue in early 2008.

Transfer Pricing: Principles and Practice

96. Transfer pricing manipulation is one of the tax planning techniques that may be used by international enterprises to minimize their overall level of worldwide taxation and the transfer pricing policies of international enterprises have an effect on the taxable profits or losses that these enterprises report in the countries in which they carry on business. **Dr. Michael Kobetsky**, Taxation Fellow, Faculty of Law, Australian National University and Senior Lecturer of the Faculty of Law, University of Melbourne, explained how the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Transfer Pricing Guidelines)* provide measures to counter transfer pricing manipulation to ensure that each jurisdiction in which an international enterprise carries on business receives an appropriate amount of revenue from cross-border intra-group trade.

97. The *Transfer Pricing Guidelines* are premised on the arm's length principle that controlled transfer prices should reflect prices used in uncontrolled transactions between unrelated entities. These rules have been enacted in the domestic law and tax treaties of many jurisdictions and as a result transfer pricing has emerged as a key tax concern for international enterprises. Transfer pricing is an area in which there are risks for both tax agencies and international enterprises as there is no single rule for determining the right transfer price; as Dr. Kobetsky explained, transfer pricing is an art not a science. The risk transfer pricing poses for tax agencies is tax avoidance, and the OECD has recently stated that 'transfer pricing is where the big bucks lie.' Transfer pricing enforcement by tax agencies creates uncertainty for taxpayers with the risk of adjustments, penalties and the potential for unrelieved double-taxation. Consequently, managers of international enterprises rate transfer pricing as their key international tax concern.

98. Dr. Kobetsky's paper provided an introduction to the transfer pricing principles and practice. The central theme of this paper was that developing countries need to both develop transfer pricing rules and enforce them to ensure that their tax bases are protected when controlled transactions are undertaken by associated enterprises

operating within their borders. To this end, Dr. Kobetsky explained how the arm's length principle is used to allocate profits of international enterprises between the jurisdictions in which they carry on business. Although the arm's length principle is internationally accepted there are problems in its practical application. Transfer pricing rules should ideally be implemented to operate at both the domestic law level and at the tax treaty level.

99. Technically, transfer pricing is merely the price at which intra-group transactions take place and is a normal incident of ongoing business activity. Transfer pricing has attracted the connotation of tax avoidance, but transfer pricing at large needs to be distinguished from transfer pricing manipulation. Transfer pricing manipulation is the intentional setting of a transfer price for a transaction by one entity with an associated entity in another jurisdiction for the purpose of reducing the aggregate tax burden of the group. Transfer pricing manipulation is a significant avoidance technique available to international enterprises and is consequently one of the major international tax issues. But while the object of reducing taxation is one of the motives influencing an international enterprise in the setting of transfer prices for intra-group transactions, it is not the only factor influencing the transfer pricing policies and practices of the international enterprise.

100. Although the most obvious motivation for transfer pricing manipulation is reducing an international enterprise's worldwide taxation, other factors may create an inducement for transfer pricing manipulation. One significant factor, for example, may be the availability of imputation tax benefits in the residence country. Some countries, including Australia and New Zealand, provide tax credits to shareholders for corporate tax paid by a company. But tax credits are only provided for corporate tax paid by the international enterprise in the residence country.

101. For transfer pricing measures to be effective a tax jurisdiction must enforce them and ensure that taxpayers comply with the rules using domestic transfer pricing rules and the transfer pricing rules in tax treaties. If a transaction between associated entities or a notional transaction between a head office and a branch of an international enterprise does not take place at a price comparable to the price for similar transactions between independent entities, in accordance with the arm's length principle, a tax agency may make a transfer pricing adjustment. But, the determination of arm's length transfer prices is not an exact method and a tax agency must use judgment in settling on an arm's length price from within a range of prices. Because of the growth in intra-firm trade, the arm's length principle is estimated to apply to 70% of cross-border trade.

102. Following a review of the rationales for the use of the arm's length principle for transfer pricing, Dr. Kobetsky illustrated some of the practical problems encountered in the application of the arm's length principle to real world examples. The *OECD Transfer Pricing Guidelines* set out five transfer pricing methods to determine whether a transfer price for a controlled transaction is an arm's length price. There are three traditional methods and two profit methods. The traditional methods compare controlled transfer prices to prices in uncontrolled transactions to determine if controlled transfer prices are at arm's length. If appropriate comparative transactions are unavailable the non-traditional methods, which focus on net profits from controlled transactions, may be used. In practice, because of the lack of comparative transactions the profit methods are most commonly used.

The Philippines' Continuing Quest for Fiscal Stability

103. After years of persistent budget deficits, the Philippines is making progress tackling its fiscal stability problems. **Ms. Lina D. Isorena**, Executive Director, National Tax Research Center, Philippines outlined the steps taken to address the issue and evaluated the effectiveness of different options pursued by the Philippines government.

104. The Philippine economy has steadily grown in recent years. The deficit has been reduced to one fifth of its level half a dozen years ago as a result of significant increases in revenue collections as expenditures reduced. However, in comparison with the other ASEAN countries, the Philippines did not do very well in terms of revenue and tax effort, in the period 2001 to 2005 ranking 7th in revenue effort and 6th in tax effort.

105. About 44% of the tax revenue comes from income taxes with the VAT contributing about 30%. VAT showed a hefty increase in 2006 (more than 60%) due to the full implementation of recent amendments which extended the VAT to electricity and increased the rate from 10% to 12%. Excise tax rates on alcohol and tobacco products have also increased, although the excise on socially sensitive petroleum products such as kerosene and diesel were reduced to soften the impact of VAT on these products. The corporate income tax rate was temporarily increased from 32% to 35%.

106. Recent changes include two important administrative developments. The first was the establishment of a system of rewards, incentives and sanctions to encourage Bureau of Internal Revenue (BIR) and Bureau of Customs officials and employees to perform beyond their revenue targets. Those who exceed their revenue goals are able to share a portion of the excess collection while those who fall short of their targets beyond a certain level can be dismissed from service. The second was adoption of an amnesty on all unpaid internal revenue taxes imposed by the national government for taxable year 2005 and prior years. In return for the payment of an amnesty tax, the taxpayer will enjoy immunity and be freed from civil, criminal and administrative liabilities under the Tax Code. But the law requires all those who will avail themselves of the tax amnesty privilege to submit a Statement of Assets, Liabilities and Net Worth which hopefully, will form part of the BIR's taxpayer database that can help improve future tax enforcement.

107. The description of these two initiatives promoted considerable discussion among conference participants. Two views emerged as near consensus views. The first was that amnesties as a general rule were not good policies. It was suggested by several participants that they may in fact be counterproductive by reducing compliance. Taxpayers who are offered a first amnesty may assume there will be future ones and will avoid paying tax in anticipation of the future ones. The second view generally adopted by participants was that incentive measures that focus on revenue targets could be seriously flawed in terms of administrative objectives. The goal, it was suggested by several participants, should be to strive for right amount of tax, not the maximum amount of revenue. Confidence that tax authorities are applying the law correctly is essential for voluntary compliance. Better indicators than revenue targets should be task targets such as increases in the level of support for clients, number of new taxpayers added to the tax base, and so forth.

108. The BIR is pursuing a number of enforcement initiatives including the so-called "RELIEF" program, a withholding matching program, and the "RATE" program. The first acronym stands for "Reconciliation of Listings for Enforcement" and is a

system that requires business entities to submit to the BIR a list of their sales and purchases to enable the Bureau to match the data on sales provided by the suppliers with the data on purchases provided by the buyers. This matching technique discloses large discrepancies in sales and purchases which can provide the BIR a basis to assess and collect substantial deficiency income tax and value-added tax from many taxpayers. Another audit tool that will be pursued is the matching of income payments of withholding agents with the reported income of recipients. Industry profiling and benchmarking will likewise be undertaken to serve as guide for the selection of firms that will undergo intensive audits.

109. The second acronym stands for the “Run After Tax Evaders” program and is based on vigorous pursuance and prosecution of high-profile personalities who have evaded their taxes. The program includes highly publicized investigations to maximize their symbolic and psychological impact on the tax paying public. It also includes improved surveillance of establishments and more effective use of business intelligence. To address the serious problem of smuggling particularly of certain excisable products, the BIR will use fuse-on stamps on cigarettes and labels on alcohol products and implement marker dye on petroleum products.

110. Another administrative strategy is to continuously improve the BIR’s tax computerization program. This program calls for an integrated tax system with a standard processing framework designed to increase revenue collections, improve taxpayer service, promote better taxpayer compliance and improve operational efficiency and transparency. The integrated tax system is a set of related systems and processes that provides maximum automation and minimum manual intervention.

111. At the same time, the BIR is seeking to broaden the taxpayer database by cleansing existing records and developing a single registry of taxpayers filers. Taxpayer profiles will be updated and there will be tax mapping of inactive taxpayers/stop filers. Third party information shall be more efficiently used as the BIR embarks on an information sharing program on taxpayers’ data through linkages with other government agencies. The matching of BIR records with Bureau of Customs records will likewise be undertaken. Finally, the BIR will improve its arrears management by cleaning up its accounts receivables and actively pursuing the liquidation of forfeited properties.

112. The present government has announced that there will be no new taxes in the near future but the government will continue to pursue certain tax policy reforms. Among these policy reforms is the rationalization of fiscal policy incentives which have exacted a great toll on the government’s ability to generate revenue. Studies show that billions of pesos were lost with the proliferation of tax incentive laws. The plan is to radically reduce these incentive laws and retain only those that are key to improving the Philippines’ competitive advantage over its neighboring countries.

113. There is no plan to simplify the individual income tax structure to improve compliance and to exempt from tax minimum wage earners. The present imbalance in the respective contributions of fixed income earners and the self-employed and professionals to the total income tax take will also be addressed by adopting measures that will ensure a bigger contribution from the professionals and self-employed.

114. With the implementation of the recent tax laws and policy amendments and the continued improvements in tax administration, the Philippines hopes to attain some measure of fiscal stability in the next two or three years. The government is

sticking to its plan to balance the budget by 2008 or 2009 at the latest, and barring any unforeseen event or circumstance, indications are that this can be achieved.

Tax Reforms in Pakistan

115. **Mr. M. Abdullah Yusuf**, Secretary-General, Revenue Division, Islamabad; Chairman, Central Board of Revenue, Pakistan, commenced a presentation on Pakistan's tax reform program with a survey of the factors that prompted reform. A strong reliance on indirect taxes led to regressivity in the taxation system, protectionism through high tariffs caused inefficiencies and an anti-export bias, taxation of production and trade activities rather than consumption and income imposed high burdens on businesses, and wide-ranging concessions and exemptions undermined the tax base. At the same time, a primitive and antiquated tax administration oversaw the imposition of complex and often arbitrary tax laws using outdated manual processes in a system of limited transparency.

116. The first generation of reforms focused on the changes to the tax rate and base. Staged reductions in the rates of personal and company income tax were adopted at the same time the bases were widened through adjustments in the threshold and withdrawal of exemptions. The customs tariff schedule was rationalized and rates were reduced.

117. The second generation of reforms targeted the tax administration system. The Central Board of Revenue, the body responsible for collecting 90% of Pakistan's tax revenue, was reorganized along functional lines while the income tax and excise tax laws and procedures were simplified. Universal self-assessment was adopted for personal and company income tax. Separate offices were established for domestic and international taxes and large taxpayer units were created. Dispute resolution committees were created to provide an alternative dispute resolution mechanism. A new tax culture designed to establish better relationships with taxpayers and to reduce the risk of harassment was promoted, manual systems replaced with automated operations, and staff education programs were adopted.

118. Modernization of the company tax system included reduction in company tax rates and harmonization of the separate rates for banking companies, public companies, and private companies with the adoption from this year of a single 35% rate for all companies. After a shift from a single sales tax rate to multiple rates, a uniform 15% rate was adopted from 2004-2005. At that time, zero-rating for exports was introduced, starting with one industry and extending to five export industries. Tariff rates have gradually been reduced and multiple rates replaced with a smaller number of rates covering multiple categories of imports. As a result of changes to the tax base, the relative importance of direct taxation and sale taxation has increased while the importance of customs duties has declined significantly.

119. Authorities have identified six areas of concern that must be addressed: the level of tax to GDP remains low in relation to competing (comparable) economies; tax compliance remains low; the VAT and income tax bases are still too small; the conversion to automated processes has not been completed; many exceptions and concessions remain; and the perception of stakeholders, while improving, remains adverse. Strategies for future reforms include further simplification of rules and procedures; continuous reduction and rationalization of tax and tariff structures; strengthening human resource management and audit functions; further adoption of automated work processes to minimize taxpayer to tax collector direct contact; and directing more effort to taxpayers' education.

Three Decades of Direct Tax Reform in India

120. The Indian economy and its tax system have undergone dramatic changes over the past three decades, a process documented for the conference by **Mr. Arbind Modi**, Joint Secretary, Tax Policy and Legislation, Ministry of Finance. The survey commenced with a period marked by a narrow tax base, extremely high tax rates, manual administrative processes, and the absence of a taxpayer information system.

121. Reform initiatives fall into seven areas. The first concerns changes to the tax rates. After an initial climb in both the top personal rate and the entry rate of tax, both figures fell over the period, with dramatic changes in the top rate from a high of more than 90% to a maximum under 40%. In contrast, corporate tax rates rose significantly, rising to 70% in the mid-1980s before dropping to their current level of 40% for foreign companies.

122. The second area of reform concerns the tax base. At the beginning of the reform period a range of incentive concessions eroded the base, with further incentives introduced until the 1990s when comprehensive reforms led to cuts in corporate rates along with removal of many incentives. But in the 1990s and early years of this century new incentives appeared until a watershed reform in 2005 when a large number of incentives were eliminated, while others expired and were not renewed.

123. A redraft of the income tax law to remove complex language and ambiguities was the third element of the reform program. Over the course of the three decades a number of attempts were made to adopt a redrafted law but all faltered. Authorities hope to try once more.

124. A fourth reform initiative was rationalization of the tax base. Three issues have been addressed: a degree of harmonization of the company and personal income taxes, reform of the capital gains tax, and measures to provide tax neutrality for business reorganizations. A securities transaction tax **was** introduced as a proxy for capital gains tax on securities.

125. A fifth issue reformers attempted to tackle was the use of tax amnesties. Following three tax amnesties prior to the 1970, in 1971 the Direct Taxes Enquiry Committee cautioned the Government that any more schemes would have a deleterious effect on the level of compliance and on the morale of the administration. The government ignored this advice and there have since been new amnesties adopted on average every five years, with the most recent being in 1997.

126. The sixth area of reform was the adoption of measures to protect the integrity of the tax base. Reformers had more success in this area with the adoption of a rule allowing the tax authority to make a pre-emptive purchase of immovable property in the event of a dispute over valuation, introduction of a fringe benefits tax, banking cash transaction tax, presumptive taxation measures, adoption of a securities transaction tax, reintroduction of the gift tax, and adoption of transfer pricing provisions based on internationally accepted arms length prices. Other measures neutralized the benefit of dividend stripping.

127. The final element of the reform agenda has been modernization of the tax administration. Changes in this area have been significant and include new payment

and reporting systems, new forms and filing processes, new systems for processing returns, enhanced audit selection systems, revamping of the refund system, establishment of a taxpayers' information network, adoption of a new administrative penalties system and a new appeal mechanism, the use of advance rulings, and an organizational restructuring.

128. The outcomes of the reform process include a rise in the level of taxation as a percentage of GDP (it currently sits at 17.85% of GDP), an increase in the relative importance of direct taxes, a reduction in the compliance gap, and improved equity in the tax system. One aim of continuing reform is to raise the total level of tax as a percentage of GDP to improve capability to deliver public goods and services and to increase the effectiveness of the direct tax system. Four benchmarks have been identified as goals for future reform: elimination of exemptions and concessional deductions, improvement of the equity of the direct tax structure, improvement of the effectiveness of the information system, and facilitating taxpayer compliance by reducing the costs of compliance.

Extending the Dialogue on International Taxation

129. The Organisation for Economic Cooperation and Development (OECD), a body representing the world's more developed economies, has emerged as the principal body responsible for establishing norms for international tax agreements. **Mr. Satoshi Ohuchi**, Senior Outreach Advisor, Unit for Cooperation with Non-OECD Economies, OECD, outlined the two approaches the OECD is taking to work with non-member jurisdictions. The first involves establishing cooperation programs with non-OECD economies and the second seeks to involve those economies in the development of the OECD model tax treaty. At the same time, the OECD is planning to expand—discussions have commenced with five initial candidates for membership and dialogue has been strengthened with five further jurisdictions.

130. Engagement with non-OECD members takes a variety of forms. At one end of the spectrum is a program of comprehensive engagement which can include full observer status. Along the scale, flexible engagement with a number of countries allows non-member countries to contribute to some OECD tax programs, while country specific development programs operate in 11 countries and regional programs operate in Latin America, Africa and Asia. Training programs are offered through regional tax centres.

131. An example of a program that spans the comprehensive and flexible engagement categories is the ability for non-members to officially state positions on the 2005 update of the OECD Model Tax Convention. At this point 25 countries have done so and another is expected soon.

132. A separate initiative is the development with the IMF, UN, World Bank and other bodies of the International Tax Dialogue (ITD) to encourage and facilitate discussion of tax matters among national tax officials, international organisations, and a range of other key stakeholders. The ITD maintains a website that provides access to a range of tax documents from countries around the globe and following the formal presentation a brief on-line tour of the site was provided. In addition to the links to ministries and tax administrations, the site provides direct access to more than 2,700 documents. Separately, the ITD sponsors international conferences on tax issues of direct interest to developing and transitional economies.