Risk Assessment in a Co-operative Compliance Context: A Dutch–UK Comparison

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Abstract

Growing pressures on resources means that tax administrations rely increasingly upon risk assessment techniques in order to enhance their regulatory efficiency. Risk-based regulation plays an important role in co-operative compliance based relationships between tax authorities and large corporate taxpayers in many countries. In return for a high level of disclosure by corporate taxpayers, tax authorities commit to a “light touch” approach in monitoring companies deemed to be low risk, while intensifying supervision of companies with a high risk profile. This article compares risk assessment techniques applied to large corporate taxpayers in the UK and the Netherlands. While both are regarded as co-operative compliance pioneers, the Dutch and UK tax authorities differ significantly in the way in which risk assessment is operationalised, whilst demonstrating similar challenges in realising administrative efficiency gains from implementing risk-based regulation. It is concluded that the benefits of risk-based regulation in a co-operative compliance framework may be easier to realise for corporate tax payers than for tax administrations. Credibility concerns, for the latter in particular, would need to be overcome in order to advance co-operative compliance.

1. Introduction

With regulatory resources under increasing pressure, risk-based regulation is used by a growing number of regulatory bodies. Tax administrations rely increasingly upon risk-based regulation in order to enhance their regulatory effectiveness. The rise of risk-based regulation in tax administrations can be seen as part of the international tax trend referred to by the OECD as co-operative compliance (CC). Tax authorities use risk-based techniques to concentrate their supervisory activities on taxpayers with a relatively higher risk profile, while those considered to be low risk are subjected to “light touch” monitoring. As part of the risk-based approach, tax

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authorities pay increasingly heightened attention to the tax operating model of companies, also referred to as the Tax Control Framework (TCF).\(^2\)

Although risk-based monitoring is a central feature of CC arrangements in many countries, the way in which risk assessments of corporate taxpayers are conducted differs substantially between tax administrations.\(^3\) Differences are also apparent in the regulatory consequences that tax administrations connect to risk assessments. In the UK, risk assessments are primarily conducted by the tax administration, whereas in the Dutch system such assessments are largely the responsibility of the company. Based upon these differences, this article investigates the question: why are risk-based approaches operationalised differently in tax administrations with advanced co-operative compliance (CC) arrangements?

In particular, the article compares risk-based regulation in two advanced co-operative compliance systems: the UK and the Netherlands. At the risk of over simplifying, in the UK, companies are assessed by HMRC, in accordance with a standard list of criteria, resulting in an ostensibly binary ranking low risk versus non-low risk. In the Dutch model of CC, known as horizontal monitoring, the risk-based approach is visible in the role of the TCF. Corporates who want to participate in horizontal monitoring need to develop a TCF, which is used by the Netherlands Tax and Customs Administration (NTCA), as the main indicator in evaluating a company’s ability to comply with tax legislation. Instead of receiving a risk rating, Dutch companies who participate in horizontal monitoring develop an action plan, in collaboration with the NTCA. The action plan sets out the company’s level of tax control, and, when necessary, the steps the company proposes to undertake to enhance its tax compliance. To analyse the different frameworks used by tax administrations, the authors draw on the literature about meta-regulation.

The rest of this article is structured as follows. In section two, risk assessments in tax administrations are placed within the broader literature on risk management and meta-regulation. This is followed in section three by a comparison of risk-based approaches in the UK and the Netherlands. Section four discusses the impact of risk-based monitoring on corporate taxpayers, and section five considers these regulatory approaches from the perspective of the tax administrations. The final section concludes the article and puts its findings in the context of wider international discussions about co-operative compliance.

The findings of this article draw upon a unique collection of interviews, conducted by the authors in 2015 and 2016 with 21 interviewees in the Netherlands and 18 interviewees in the UK. Each interview lasted on average one hour and interviewees were all tax specialists: tax administrators; tax professionals based in large companies; or tax advisers. Interviewees were recruited based upon their knowledge of and/or involvement with the risk assessments. In addition, the article draws upon primary and secondary material, such as policy documents from tax administrations and tax advisers.


2. On the logic of risk assessments

In the academic literature dealing with the regulation of risks, various scholars have attempted to categorise risk in different ways. Some take the regulatory body as the object of study, others take those that are subjected to regulatory control. Within this literature, the term “meta regulation” has evolved to describe how regulators manage their own risks in part by considering the robustness of the internal controls of those they regulate. Growing pressures on resources have incentivised regulators to apply a meta-regulation approach as an alternative to traditional, command and control based regulation.

Braithwaite explicitly talks about meta-regulation in the context of tax administration. He suggests that risk management by tax authorities has been conventional in terms of merely analysing more closely the risks faced by the organisation. He posits that a further stage is required, for tax authorities to try to influence, or “remake” the risk management systems of the organisations that it is responsible for regulating. In a later work, Braithwaite describes meta-risk management in the tax administration context as consisting of a shift from “inside out” to “outside in” design. By this, he means that the tax authority needs to move away from the traditional approach of designing tax systems to suit administrative purposes and then requiring taxpayers to comply with them, to an approach that engages taxpayers by shaping the tax system to “go with the grain of user systems”.

Meta-regulation, however, also contains risks. Black expresses concern about how risk-based regulation has “the potential both to expose and obscure key socio-political and socio-economic choices”. These choices relate to, for example, the amount or types of regulatory failures that a regulator will tolerate. A second risk, which has been identified in relation to the Sarbanes–Oxley regulations, is that meta-risk regulation may lead to an environment of over-regulation that could impede business progress and innovation, and reduce the competitiveness of a country as

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7 J. Braithwaite, Markets in Vice, Markets in Virtue (Oxford: OUP, 2005), 156.
a place to do business. However, regulators and others will argue that, due to continued tax avoidance activity, meta-risk regulation should in fact be developed and increased. From this perspective, an adequate system of meta-regulation enhances taxpayer’s trustworthiness. Another risk of meta-regulation is that regulators might become captured by the regulated entity.

The literature provides few insights into the manner in which tax authorities implement meta-risk regulation. Hence, we know very little about why tax authorities implement different types of meta-risk regulation, and what the effects are of different institutional design choices on the relationship between corporate tax payers and tax administrations. It is also unclear under which circumstances meta-risk regulation constitutes the most adequate form of regulation, and what the regulatory focus of tax authorities should be. Should tax authorities solely monitor the risk management processes and systems of taxpayers, or should they also try to nudge them, or, one step further, control them? Before analysing the impact of risk assessment techniques on companies and tax administrations, the next section first provides a general overview of these techniques in the Dutch and UK systems.

3. The risk assessment

Growing pressures on the resources of tax administrations and deteriorating relationships between the corporate sector and tax administrations incentivised the development of CC-based relationships in the Netherlands and the UK in the 1990s. The new regulatory approaches put emphasis on more collaborative relationships—in exchange for increased openness by corporate taxpayers, tax administrations commit to improving the customer management of corporate taxpayers, and to adjust their supervision based on the fiscal profile of individual companies. Although the Dutch and UK CC working methods show distinct differences, a risk assessment procedure to determine a company’s adequate level of supervision is a core feature of both systems.

In the UK, HMRC use a variety of assessment criteria to determine the risk profile of corporate taxpayers. There are seven risk factors in total, and, except for one, they are divided between inherent and behavioural risk factors. Inherent risk factors relate to features inherently linked to a company, which in themselves create risks. HMRC use three subcategories to categorise these risks: complexity; boundary; and change. Complexity relates to risks that occur due to the size, scope and depth of the tax interests of a business; boundary relates to the level of complexity of its international structures, financing and connected party issues; whereas change focuses on tax risks that may occur due to the degree and pace of change facing a business. The behavioural

risk dimension is assessed against three factors: the corporate’s governance; its previous fiscal compliance track record (referred to as “delivery”); and its tax strategy. In addition to the inherent and behavioural risk factors, companies are assessed on their tax contribution, and whether their tax declarations reflect what is known about the business and the sector it operates in.

The main responsibility for assessing a company’s risk profile rests with the Customer Relationship Manager (CRM), tax administrators assigned to the businesses organised under HMRC’s Large Business Directorate. The Large Business Directorate contains the UK’s 2,100 largest businesses. It is the task of CRMs to score companies’ inherent risk factors on a four-point scale, ranging from major, significant, moderate, to low risk. HMRC’s internal manual Tax Compliance Risk Management\(^{15}\) lists illustrations of each risk factor for each of the four different risk levels. For example, regarding the inherent risk factor “boundary” a major risk feature mentioned is whether a business has “foreign owned entities within the business”, while a low risk feature is a business with “no transfer pricing transactions”. Illustrations are also listed for the behavioural risk indicators, in which case CRMs classify companies in four categories (starting with “low risk”, and followed by three categories indicating variations to the low risk definition: “tends to reduce risk”; “tends to increase risk”; and “increases risk”).

In the Dutch system of horizontal monitoring, the TCF constitutes the critical indicator for the NTCA to assess a company’s ability to manage its tax risks. Although the TCF was not part of the initial pilots that were organised to introduce horizontal monitoring, as the new supervision model expanded the NTCA quickly felt the need to have an objective framework in place to decide on a company’s admission to horizontal monitoring. In contrast to the UK, companies audited under the Dutch horizontal monitoring regime have to voluntarily make the decision whether they want to join the horizontal monitoring regime. Participation in horizontal monitoring is open for all businesses, although only businesses classified as part of the Large Business Division will conclude a covenant with the NTCA. Currently, around 9,600 companies are part of the NTCA’s large business section.\(^{16}\) Once a business indicates interest in horizontal monitoring, the NTCA starts a procedure to assess its suitability to join the programme. The standard entrance process to horizontal monitoring consists of three phases. The first phase is aimed at exploring the feasibility of horizontal monitoring for the organisation. A meeting is organised between the NTCA and the company’s senior management at which the tax administration explains horizontal monitoring to the company, including the steps the company would be required to undertake to enter the programme. The introductory meeting also enables the Dutch tax administration to get an impression of the fiscal attitude and behaviour of the company’s senior management (“tone at the top”). The first stage is concluded by drafting a client profile, which outlines the favourable and unfavourable elements of the current relationship between the NTCA and the company.

\(^{15}\) HMRC, above fn.14.

\(^{16}\) Between 2008 and 2013, the NTCA’s Large Business Division was officially divided into a section for very large businesses (around 2,000), and a section for medium-sized businesses (around 10,000). Since 2013, the sections have been merged, with the exception of the smallest medium-sized businesses, which were transferred to the already existing Small and Medium-Sized Enterprises segment. According to interviewee NL05, “large companies” are businesses with revenues of more than €10 million.

If the company indicates continued interest in horizontal monitoring, and there are no fundamental objections in the eyes of the NTCA, both parties embark upon the second stage of the process, which is a compliance scan conducted by the tax administration, in collaboration with the company. In contrast to the general exploration during the first stage, the compliance scan is aimed at reviewing the feasibility of horizontal monitoring for the company. As part of the scan, the NTCA interviews a number of the company’s key officers (normally two to five) to acquire more knowledge about the company’s tax attitude, and its ability to achieve an adequate level of fiscal control. The main question to be clarified during the review is whether the NTCA has “gained the impression that the organisation is willing to gain tax control (in the longer term) and is transparent about tax issues”.

Topics to be discussed in relation to the tax function include the company’s strategic objectives, its internal control environment, such as IT systems, and the external monitoring and advice the company receives.

The NTCA will consider it feasible for the company to join horizontal monitoring unless there are indications to the contrary. When the compliance scan does not raise fundamental issues, and both the tax administration and the business are positive, the relationship is confirmed in a compliance agreement, or covenant, which is a standard text outlining the future working relationship. The covenants are concise—mostly one to two pages—and concentrate on the intentions of both parties to develop a co-operative relationship, without detailing the terms and standards referred to in the compliance agreement. Due to legal equality, procedural efficiency and neutrality requirements, variances from the standard text are not permissible. In the rest of this article, companies who have joined the Dutch horizontal monitoring are referred to as covenant-companies, while those who have not joined are referred to as non-covenant companies.

The entry process to horizontal monitoring shows that even though a company’s tax position is thoroughly examined as part of the compliance scan, the decision as to whether or not a company is allowed access to the programme is mainly based upon its level of transparency and willingness to gain tax control. Hence, while some companies might already possess a high level of tax control, others may only be able to achieve such control in the longer term. With regard to companies in the second category, the NTCA assumes that once a company has signed the compliance agreement it will be dedicated to improving its internal (tax) control procedures and its ability to monitor those procedures. Hence, evaluation of the TCF is based firmly upon self-assessment and it is the company who, according to the NTCA guidelines, “bears the responsibility for its TCF”.

To evaluate a company’s performance in developing its TCF, the NTCA expects companies to develop an action plan that should specify the work it plans to undertake in order to progress from its actual to its required level of tax control. When a company claims that it is already at a level where no further improvement is necessary, it has to demonstrate that it is at that level through an analysis carried out by the company itself. Dutch tax officials indicate that some companies have difficulty in demonstrating their level of tax control:

“Sometimes businesses think they are able to submit correct and complete tax returns. However, if you then ask them, ‘OK, show us why you think that’, you get replies like ‘I

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18 NTCA, above fn.17, 19.
19 NTCA, above fn.17, 24.
20 NTCA, above fn.17, 15.
have such a good colleague working in the tax department’, or ‘my tax colleague has been here for over twenty years.’ Of course, that should not be a reason that everything is all right. This explains why some companies have to invest some time and energy to show their level of fiscal control.” (NL06)

An important part of the Dutch action plans is the incorporation of monitoring techniques that should ensure that a company will be able to identify any shortcomings in its TCF and rectify them before they result in misstatements in the company’s tax returns. Again, the NTCA leaves it to the discretion of the company to decide on the design of its internal monitoring system. However, it does articulate a preference for statistical sampling, as this would align the company’s monitoring system with the main auditing method of the tax administration. Table 1 provides an overview of the Dutch and UK risk assessment systems.21

| Table 1: risk assessment in a co-operative compliance context |
|----------------|------------------|------------------|
|                | UK              | The Netherlands  |
| **Applies to** | All large companies—around 2,100 | All companies applying to horizontal monitoring (compliance scan) and those part of horizontal monitoring—around 40% of 9,600 companies |
| **Main risk assessment criteria** | Inherent and behavioural risk factors, tax contribution | Level of transparency and willingness to gain tax control |
| **Main actor responsible for risk assessment** | HMRC—Customer Relationship Manager (CRM) | Company |
| **Main outcome** | Low or non-low risk | Covenant company or non-covenant company |

Despite their similarities, the UK and the Netherlands use significantly different systems to assess the fiscal risk profile of companies. While the rating is ostensibly binary in the UK (low risk versus non-low risk),22 the Dutch system contains a two stage risk rating process. The compliance scan carried out during the first phase decides whether a company is able to enter horizontal monitoring, while the action plan drafted during the second phase provides the main input in order to decide the level of supervision to which a company will be subjected. In the next section of this article the authors will consider how the two risk assessment methods are implemented in practice, and will analyse their consequences for both corporate taxpayers and tax administrations.

4. Impact on corporate taxpayers

Greater certainty and faster interaction with the tax administration are the main incentives for companies in the UK to acquire a low risk rating, and for companies in the Netherlands to join horizontal monitoring. Although in theory being rated low risk, or being part of horizontal

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21 Risk rating methods are also used for companies which fall outside the category of large companies, but since these methods differ from those applied to large companies, the discussion here is limited to large companies.

22 In practice, the UK risk rating is more nuanced and some gradation is recognised by HMRC within the overall “higher risk” category, such as a “moderate risk” category. Cf. J. Freedman, G. Loomer and J. Vella, “Corporate Tax Risk and Tax Avoidance: New Approaches” [2009] BTR 74.
monitoring, provides clear advantages to corporate taxpayers, some of the authors’ evidence points in a different direction.

**Impact for companies in the UK**

In the UK, HMRC leave no space for misunderstanding regarding the consequences of having a low risk status: low risk companies will not receive a further risk review for three years and in the interim HMRC will generally not challenge a company’s tax returns, although some contact with HMRC will take place annually to discuss wider structural and organisational issues.23 Companies in the UK have different views about the advantages of having a low risk rating. In a survey conducted by Freedman et al. 13 out of the 25 interviewees indicated that they could see the benefits of being rated low risk, such as “fewer enquiries, obtaining formal and informal clearances with greater ease, and being approached by HMRC with a less suspicious frame of mind”.24 These authors’ interviewees listed similar advantages of being rated low risk together with the corresponding reduction in administrative burden. An additional advantage for companies as stated by HMRC is that low risk companies are trusted by HMRC to raise any tax issues, which “enables low risk businesses to set the agenda”.25

Other interviewees, however, emphasised the negative consequences of having a low risk rating. First, some corporate interviewees suggest that having a non-low risk rating guarantees more support and a closer relationship with HMRC compared to being rated low risk. Secondly, and this is particularly emphasised by tax advisers, having a low risk rating could indicate that a company, or its adviser, does not adequately protect the corporate’s tax interests. In the words of one interviewee “to get a low risk assessment means you’re not doing your job properly, because you’re too compliant!” (UK06). Thirdly, interviewees point to moral hazards because companies who do not necessarily have high compliance levels may try to obtain a low risk rating in order to “make the Revenue [HMRC] go away” (UK06).

Interviewed UK tax advisers and in-house corporate tax professionals most strongly criticise the methodology used by HMRC to conduct the risk ratings. Overall, criticisms concentrate on the inherent risk factors, which are seen as making it virtually impossible for large companies to receive a low risk rating. One corporate tax professional remarks on this:

> “Actually, we think that the risk rating is completely unhelpful and doesn’t say anything more, because most large corporates with big international operations are almost inevitably going to be non-low risk; because there’s just so much transfer pricing, so much complexity, they’re just unlikely to be low risk. We do know very large, complex companies that are low risk, but I think it’s very hard to get there, even if you’re an extremely cooperative company, as we are.” (UK04)

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24 Freedman, Loomer and Vella, above fn.22, 86.

To counteract the impression that large companies are unable to receive a low risk rating, HMRC explicitly state in their Business Risk Review guidelines\textsuperscript{26} that they have rated complex businesses as low risk. However, no figures are released by HMRC regarding the number of companies which have received either a low or non-low risk rating.

Some interviewees are sceptical about the impact a low risk rating has in practice on their relationship with HMRC. For example, one corporate tax professional indicates “we believe that HMRC doesn’t think it matters very much whether you are low risk or non-low risk” (UK05). Partly due to its ambiguous status, the impact of the UK’s risk assessment method on the internal control structure of companies has remained limited. Instead, various new regulations introduced in recent years seem to have had more impact on the tax control structure of UK companies than the soft pressures resulting from the risk rating. Particularly relevant is the Senior Accounting Officer (SAO) legislation introduced in 2009\textsuperscript{27} and the more recent requirement for companies to publish their tax strategy.

The SAO legislation requires that senior accounting officers from UK companies with a minimum turnover of GBP £200 million, or a balance sheet of more than GBP £2 billion, sign an annual declaration that “appropriate accounting arrangements” have been used to calculate the company’s tax liabilities. In the event of these arrangements falling below this standard, the SAO is personally responsible and subject to a financial penalty of GBP £5,000 per instance.\textsuperscript{28} Although the penalty is perhaps not significant in itself, the fact that it is levied personally on the SAO could have significant reputational repercussions, and many companies indicate that they had to make significant changes in their organisation to comply with the SAO legislation,\textsuperscript{29} particularly as the imposition of a penalty implies that the control framework of the company is inadequate.\textsuperscript{30} Another requirement imposed in 2016 is for companies to publish their tax strategy.\textsuperscript{31} Although companies will not be required to publish evidence that the strategy is being applied, their risk rating may be upgraded if returns appear to be materially inconsistent with what the company says in its tax strategy.\textsuperscript{32}

**Impact for companies in the Netherlands**

Interviewees in the Netherlands emphasise the advantages generated by holding the status of covenant-company. However, they also list features that are making it (increasingly) difficult

\textsuperscript{26} HMRC, above fn.14, TCRM3100.
\textsuperscript{27} FA 2009 Sch.46. For a discussion of the introduction of the SAO legislation, see J. Freedman, “Finance Act notes: section 93 and Schedule 46 — duties of senior accounting officers of large companies” [2009] BTR 620.
\textsuperscript{29} A. MacPherson, M. Kennedy, J. Egert and B. Lucas, “United Kingdom” in A. Bakker and S. Kloosterhof (eds), Tax Risk Management: From Risk to Opportunity (Amsterdam: IBFD, 2010), 405.
\textsuperscript{30} The authors are grateful to an anonymous reviewer for making this point.
for horizontal monitoring to deliver on its promises. The authors discuss both the positive and negative aspects of the covenants.

First, interviewed corporate tax professionals indicate that having a covenant significantly reduces the workload of corporate tax departments. Prior to horizontal monitoring, large companies in the Netherlands regularly had outstanding tax issues with the NTCA, going as far back as eight or nine fiscal years. This backlog in tax returns led to a stagnation of the Dutch tax system, absorbed growing resources from both the corporates and the tax administration, and led to frequent disputes. A second advantage is that covenant-companies acquire certainty faster with respect to the fiscal implications of future business decisions than do non-covenant companies. Although the ability to acquire certainty is a longstanding feature of the Dutch tax system, the introduction of horizontal monitoring has enabled the NTCA to speed up this process for covenant-companies. One Dutch tax official provided an example of increased certainty by referring to the Dutch ruling practice:

“We have an APA/ATR-ruling practice, and they can be consulted by every company. The difference for covenant-companies is that we can give them certainty faster because we have more knowledge about covenant-companies, hence we have greater certainty that the facts they provide are correct, and more certainty that they will be able to implement the ruling properly. Although the process of acquiring a ruling is the same for all companies, the greater degree of openness by covenant-companies means that we can provide them with certainty more quickly than non-covenant companies.” (NL06)

A third advantage of horizontal monitoring is that it promises covenant-companies more predictability regarding the future actions of the NTCA. The strategic treatment plan sets out what the NTCA plans to do in the short and long term. Due to this, covenant-companies will be able to know, for example, when they will be subjected to an audit. The sharing of the strategic treatment plans should occur on a regular basis; once a year for the largest companies, and once every two years for the large companies. However, interviewees indicate that due to resource capacity pressures in the NTCA, this often does not happen in practice.

Another complication for companies is that the NTCA has left the decision about the operationalisation of the TCF largely to individual companies. It is the companies that have to demonstrate to the NTCA that the organisation of their tax function will ensure that the company will raise all important fiscal issues with the NTCA, as it is required to do when it is a covenant-company. In its policy, the NTCA only refers to the general rule formulated in the Dutch General Law on National Taxes that requires companies to keep books and records of their financial position. This is an open standard that only states that the administration must comply with the requirements of the business, as formulated by the company’s dedicated administrator (which can be anyone within the organisation). Hence, the norm provides limited direction for companies, and the majority of interviewees from all sides in the Dutch tax field indicate that many companies would appreciate more feedback from the NTCA on their TCF. The call for more guidance is strongest among Dutch tax advisers. This appears to have mainly a commercial background, since having clear guidelines formulated by the NTCA would offer

33 General Law on State Taxes (Algemene Wet inzake Rijksbelastingen, AWR) art.52.
the advisers a strong business case for developing the TCF into a product they can sell to companies. Notwithstanding reluctance by the NTCA to provide content to the TCF, a substantial number of guidelines have been issued by Dutch tax advisers in recent years, especially from the Big-4, to support businesses in improving their level of fiscal control.\footnote{34See for example Deloitte, Horizontaal Toezicht, available at: https://deloitte.ctrl.nl/nl/services/tax-control-framework.aspx [Accessed 12 April 2017].}

**Similarities in administrative impact in the UK and the Netherlands**

In both the Netherlands and the UK, interviewees indicate that being part of a CC relationship might lead to a selective use of openness by corporate taxpayers towards the tax authority. Due to the continuous monitoring of a company’s risk profile, and the importance put on the relationship between the tax administration and the corporate taxpayer, companies may not want to negatively affect their CC relationship by sharing information that is likely to be perceived critically by the tax administration. However, several interviewed corporate tax directors mentioned another effect of the risk-based CC models; namely, companies becoming too cautious in their fiscal position as they do not want to run the risk of harming their valued relationship with the tax authority.

Corporate tax directors also indicate that the emphasis put on openness in a CC relationship cannot always easily be translated in practice. The guideline that every issue about which doubt may exist needs to be submitted to the tax authority can cause confusion and tensions between companies and the tax administrations. Or, as put by one interviewed tax adviser: “What may be seen as a question of black and white in the eyes of a corporate tax director, and hence is not disclosed, may be grey in the eyes of the tax authority, and hence had to be disclosed” (NL20). Although the authors did not find evidence of significant conflicts, differences in opinion as to when an issue needs to be submitted to the tax authority in a CC relationship do cause frictions between tax authorities and corporate taxpayers.

Another similarity is that in both systems some of the companies in a CC relationship articulated a concern about receiving a low risk rating, as this may result in the nearly complete disengagement of the tax authority. These companies instead valued their interaction with the tax authority, including the tax authority’s audits “so we can know if we are doing things well” (NL02).

**5. Impact on tax administrations and explanation for chosen risk assessment methods**

The major assumed benefits for tax administrations of using risk rating techniques are that these techniques enable the administrations to acquire more systematic knowledge of the real-time tax risks facing taxpayers, and to use this information to better allocate supervision resources. These techniques are then expected to increase the overall effectiveness and efficiencies of the audit practice of tax administrations. Whether or not this impact can be identified in practice will now be discussed, together with the wider implications of CC on the relationship between tax administrations and corporate taxpayers.
Similarities in impact in the UK and the Netherlands

In both systems, risk assessments raise expectations among companies which are rated low risk. In return for a high level of transparency, low risk companies expect the tax administration to fulfil its obligations as part of the working arrangement. CC companies in the Netherlands and the UK hold rather similar expectations—on the one hand, a more collaborative relationship with the tax authority, resulting in speedier interaction and a higher level of certainty provided by the tax administration, and on the other hand more intensive supervision by the tax administration of non-CC companies (reflected in comments such as “going after the bad guys” (NL06)). With regard to both aspects, tax administrations are criticised by companies for not fulfilling their obligations. First, CC companies in the Netherlands and in the UK criticise the tax administration for becoming slower in responding to companies’ requests for clearances, which in turn results in less certainty for companies. This slowness in response seems to be influenced at least in part by current societal and political developments. One Dutch corporate tax professional remarks on this:

“There is a risk that if one of the parties … retreats, there is then an additional negative impact because you actually strongly rely upon that relationship that you always have. And what I have been seeing lately, perhaps not so much in direct taxes, but especially in the area of indirect taxes, is diminishing availability and accessibility of the tax administration to quickly get to business and to get a quick reply to questions, or to be able to discuss certain things quickly. And this is particularly due to Brussels, which means that they [the NTCA] put increasing emphasis on policy unity, as it is aptly called, but of course this has a negative impact on what happens in our company, because we always assumed that we were able to make those quick decisions.” (NL10)

Secondly, due to the significant resource requirements of CC-like working relationships it has proved to be more difficult than expected for HMRC and the NTCA to intensify their supervision of companies that do not want to be co-operative with the tax authority, and which therefore demonstrate a high risk of non-compliance with the tax laws. Besides likely losses in collected tax revenues, interviewees indicate that failure by the tax administrations to increase scrutiny of high risk companies has a demotivating effect on companies that optimise their internal tax control and make an effort in their relationship with the tax authority. The interviews have revealed that, so far, these companies have found the tax authorities to be deficient in their reciprocation of these obligations. Further illustrations of the impact on the tax administrations are detailed below.

Impact on the NTCA and HMRC

The major challenges to the risk assessment conducted as part of Dutch horizontal monitoring are the level of resources and expertise required from the tax administration to properly implement the model. Although the responsibility for the TCF rests with the company, the NTCA is supposed to discuss the framework with the company, and, by using the company’s own action plans, to
provide the company with feedback on its planned steps to improve its TCF. This method does not only require a high level of insight into the commercial and tax structure of companies, but also puts high demands on the NTCA’s resources.

In both the Netherlands and the UK, risk assessment methods have incentivised the development of guidelines by the tax administrations to improve a corporate’s level of internal control. The NTCA has specified a number of areas for attention which, in the NTCA’s view, would strengthen a company’s level of internal control. However, the guidelines are formulated in general terms. Hence, several interviewees, including Dutch tax officials, indicate that the NTCA could play a more active role in providing feedback to companies so as to further develop their TCF. However, the NTCA continues to be cautious about not taking on the full responsibility for developing the TCF. One Dutch tax official observed:

“I sometimes receive comments from companies that when they ask their tax inspector for feedback on their TCF the tax inspector says nothing except ‘that is your responsibility’. I think we should be able to provide more guidance; however, we shouldn’t develop this one-sided. Because then, essentially, tax advisers will receive a checklist with which they can go to the companies with the message: ‘the NTCA expects you to implement this and it would cost you this amount of money when we do it for you’. Instead, all parties in the tax triangle should work together to further develop the TCF.” (NL21)

There are multiple reasons as to why the NTCA has decided not to provide a blueprint for the TCF. The main reason stated is that every company has its own dynamics and needs in terms of fiscal control, hence every TCF will be unique as it needs to be adjusted to a company’s specific profile. The decision of the NTCA is understandable given the diversity in companies’ tax risk profiles; a listed company with global activities can be assumed to be in need of a different tax function compared to a company that is part of the NTCA’s smallest segment of large companies and only operates domestically. Another tax official lists the potential risks if the NTCA were to provide a blueprint:

“If you do impose it [the TCF], and companies adhere to it and it does go wrong, then who is responsible? We, the NTCA, because we put a green check mark at the company’s TCF? Then we would go back to the old paradigm where we were taking responsibility for something the companies actually need to do internally.” (NL15)

While the NTCA’s decision not to provide a blueprint for the TCF is understandable, the NTCA’s reluctance to provide guidelines puts tax officials in an ambiguous situation. After all, it is largely on the basis of the TCF that tax officials determine the level of supervision a company will receive. Another Dutch tax official comments on this ambiguity as follows:

“The idea is, the company shows its level of tax control to us, because it is the company that must make this analysis. And their own analysis should show where they are aiming to improve, and how they are planning to do that. The transparency is in sharing that

35 For example, in its guidelines the NTCA states that it will indicate to the company whether it recognises the risks that are included by the company in its action plan and, where relevant, promises to supplement these with risks it has identified. Source: NTCA, above fn. 17, 33.

36 NTCA, above fn. 17, 28.
information with us, and we can then provide feedback on that. However, you may not ask us ‘Is everything now complete?’, as if we are an adviser, or ask us how to arrange certain things. But we do give suggestions if we miss or do not see something. In practice, you can sometimes find yourself in situations where you say, yes, I am ending up here in the corner of the adviser and that is not my task. However, you should be able to say something of what you think to a company. And that does not imply you are giving a judgment on its TCF, because you focus on the tax return, but keeping this distinction can be difficult in practice.” (NL06)

The most suitable moment for the NTCA to provide suggestions to a company on its TCF is when it shares the strategic treatment plan with the company. However, interviewees indicate that the NTCA faces difficulties in realising its ambitions with respect to the strategic plans. One tax official states that the NTCA does “a terrible job” (NL17) in sharing the strategic treatment plans, with the plans being shared with only a minority of the companies (“if we share them with twenty percent of the companies, that would be [too] much” (NL17)). The NTCA’s difficulties in sharing the plans partly result from capacity problems. Although horizontal monitoring was expected to result in efficiency gains, in practice the model continues to absorb a larger amount of staff capacity than the NTCA hoped for at the time of its introduction. Partly due to capacity issues, the monitoring of the TCF, as well as the strategic planning on how to improve it, regularly receives limited attention in practice. Staff pressures also explain why the NTCA decided in 2013 to no longer share the strategic treatment plans with the smallest segment of the large company division on an annual basis, but to do so instead every three years (for example, NL06 and NL17). It is not only organisational pressures, however, but seemingly also attitudes among tax officials that make it difficult to share the action plans. One interviewee pointed to the “risk aversion” of many tax administrators, which makes it difficult for tax administrators to communicate with corporate tax professionals where the NTCA plans to conduct its supervision in the upcoming years “because then you have agreed on something” (NL17).

In both the Dutch and the UK system, being in a CC relationship does not imply that a company is expected to demonstrate 100 per cent tax control. Instead, failures are allowed, and interviewed tax officials emphasise that it would be suspicious if such failures never occurred. One Dutch tax official comments about this:

“I have experienced companies who had been caught for tax fraud, but were so shocked by the incident and really committed to not letting it happen again, that they became the best covenant-companies. I always say converts are the most fanatical ones. However, the opposite can also happen, where a company that initially demonstrated a high level of commitment and compliance after a while starts to demonstrate, for whatever reason, awkward behaviour.” (NL21)

Although, in both the Dutch and UK systems, non-compliance does not automatically remove CC status from a company, failures must not be indicative of significant or ongoing risks. While exact figures are not available, Dutch tax officials indicate that a “couple of covenants” (NL17) were discontinued in recent years. In line with this, one Dutch tax official emphasises that the NTCA does not have a policy where it says “we must, at all costs, maintain the covenant” (NL15). Discontinuing covenants, however, does confront the NTCA with a dilemma because, in contrast
to HMRC, the NTCA does not possess specific risk or monitoring techniques for companies outside horizontal monitoring, except for traditional supervision. Hence, the decision to discontinue a covenant is taken with great caution, as the NTCA might have a better prospect of changing the unco-operative behaviour of a company while it remains within horizontal monitoring, compared to when it has left the supervision regime.

In the UK, downgrades of a company’s risk profile regularly occur. At the extreme, for companies that “persistently engage in aggressive tax planning and/or who refuse to engage with HMRC”,[37] the UK tax authority has had a so-called special measures regime in place since 2015. The measures allow HMRC to impose sanctions on this category of companies, the number of which is very small, such as removing access to non-statutory clearances, removing the defence of “reasonable care” or naming the respective companies as being in special measures. [38]

The risk assessment method conducted in the UK confronts HMRC with many similar challenges to those faced by the NTCA. Both tax administrations struggle to find a balance between an adequate implementation of CC-based regulations for large corporate taxpayers, and having sufficient administrative resources available for other groups of taxpayers (for example, small and medium businesses, and individual taxpayers). There are also differences in impact between the tax administrations. Tax officials in HMRC are expected to have greater insight into commercial and tax structures than their Dutch counterparts, as, in contrast to the NTCA, HMRC tax officials carry the main responsibility for determining the risk profile of companies. Risk assessment techniques are used less frequently by HMRC as an instrument to improve a company’s tax control structure. This is due to a preference demonstrated in practice by HMRC for applying a direct regulatory approach, rather than using the risk rating as a carrot to incentivise companies to strengthen their fiscal control structure. It needs to be emphasised, however, that despite the greater role of HMRC tax administrators in the risk assessment process compared to their Dutch counterparts, the risk rating received by corporates will be the outcome of a dialogue between tax administrators and corporate taxpayers, hence, providing UK corporates with some opportunity to influence their risk rating.

Motivations for chosen risk rating methodologies

The wider risk management context needs to be taken into account to understand why the two selected tax administrations opted for different risk rating methodologies. In the Dutch system, expanding the number of companies participating in horizontal monitoring had been an explicit objective of the Dutch tax administration since the introduction of the model back in 2005. The main reason for the focus on expanding the covenants is that the number of covenant-companies was seen as an important indicator of tax compliance by Dutch corporate taxpayers. Prominent in the international literature, the term “compliance” has become increasingly popular in the Dutch tax administration since the early 2000s. In this context, the view was widely shared that traditional indicators used to determine the NTCA’s performance, such as the number of audits conducted, provided little information on the actual compliance status of corporate taxpayers.

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[38] HMRC, above fn.37. Several commentators, for example Freedman and Vella, above fn.31, have expressed concern that the measures are not narrowly targeted enough.
Hence, new compliance indicators were sought to include in the performance contracts between the NTCA and the Dutch Ministry of Finance. Following the positive evaluation of the horizontal monitoring pilots of 2005 and 2006, the number of concluded covenants between the NTCA and corporate taxpayers started to be used as a compliance indicator. The pressure which resulted did not only lead to a rapid expansion of horizontal monitoring from the initial group of very large businesses to businesses of all sizes, but also led to the inclusion of companies who still had a long trajectory to follow before they were able to achieve the high level of fiscal control required. One tax official comments on this period:

“The covenants were concluded far too quickly. Tax officials felt responsible for realising the targets. They said to companies: ‘If you agree a covenant with us, you will never be audited again’. But that is a misinterpretation of the intention of horizontal monitoring. Covenants were also concluded with companies who didn’t sufficiently realise what they agreed with, especially the level of openness they were expected to demonstrate.” (NL18)

The first large-scale independent review of horizontal monitoring conducted in 2012 also criticised the rapid expansion of the new regulatory model, which was observed as particularly problematic in light of the lack of empirical data regarding the impact of horizontal monitoring on the actual compliance levels of corporate taxpayers. Due to the lack of in-depth evaluations, it has also proven to be difficult to generalise the effects of CC frameworks on, for example, collected taxes.

In both the UK and the Netherlands, CC has not (yet) received the reputation of having significantly increased the efficiency of the tax administration (for example, several interviewees qualify the CC working relationships as “relatively expensive”). However, it is not possible to conclude this in any concrete way, as it has proven difficult to measure the impact of the regulator in a CC-based tax framework. Whereas under traditional regulation the amount of additionally collected revenue can be precisely determined, for example as generated via audits or fines, it is far more challenging to demonstrate the regulator’s impact in a system where the regulator focuses on the process of regulation rather than the regulatory activity itself. In addition, many of the (indirect) tax effects of CC are hard to quantify, for example the potential effects on business investment decisions. Due to this, CC working methods do face credibility issues in the Dutch and UK tax administrations, which are aggravated by the fact that most divisions in HMRC and the NTCA face continuous cuts in staff and resources, while their large business sections have remained largely untouched, or have experienced an increase in resources. The credibility issues seem more challenging for the NTCA than for HMRC due to the more rapid expansion of CC in the Netherlands, the more substantial administrative resources dedicated to

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39 Committee Horizontal Monitoring Tax and Customs Administration, Tax supervision — Made to measure. Flexible when possible, strict where necessary (The Hague: June 2012), available at: [http://download.belastingdienst.nl/belastingdienst/docs/tax_supervision_made_to_measure_zz0151z1fdeng.pdf](http://download.belastingdienst.nl/belastingdienst/docs/tax_supervision_made_to_measure_zz0151z1fdeng.pdf) [Accessed 13 April 2017].

40 Committee Horizontal Monitoring Tax and Customs Administration, above fn.39.

it, and the more significant regulatory consequences in terms of supervision for companies holding a covenant status.

6. Summary and conclusions

When comparing the Dutch and UK systems for risk assessment several observations can be made. First, by having a separate programme for businesses in a CC relationship, the Dutch model has a clear assessment phase during which a company’s suitability for a CC relationship is evaluated. In the UK, in contrast, there is no demarcated CC programme to which businesses can apply; hence all companies that are part of HMRC’s Large Business Division receive a risk assessment. Both the group of participants and also the way in which risk assessment systems are conducted are significantly different between the UK and the Netherlands.

In the Dutch system, the main criteria centre on a company demonstrating the intention to improve its TCF, and presenting a convincing plan as to its implementation to the tax authority. Although similar to the NTCA, in assessing companies based upon their behavioural features, HMRC also place emphasis on risk features that are inherently linked to a company’s structure, and hence cannot be influenced by the company’s management. Companies in the Dutch system are better able to affect their risk assessment, which, when compared to the UK, provides a stronger incentive for companies to improve their tax function. While companies in the UK seem to feel that they cannot significantly affect their risk rating due to the emphasis on inherent risk factors, they also appear to feel that the risk assessment seems to make little difference in practice to their relationship with HMRC (for example, UK04 and UK17). As the Chancellor’s Spring Budget 2017 contains the announcement that there will be a consultation on HMRC’s process of risk profiling of large businesses, it would seem that the limitations of the current risk profiling methodology are being felt beyond corporate taxpayers.\footnote{HM Treasury, \textit{Spring Budget 2017} (London: March 2017), available at: \url{www.gov.uk/government/uploads/system/uploads/attachment_data/file/597467/spring_budget_2017_web.pdf} [Accessed 21 April 2017], 36.}

Risk management strategies have been at the core of the transformation of supervision structures for large businesses in the UK and the Netherlands. The findings of this article demonstrate that the methods used to conduct risk management for large businesses strongly resemble features of meta-regulation. The TCF is observed by all Dutch tax actors as one of the fundamental challenges determining the future of horizontal monitoring, and as such CC in the Netherlands. Tax administrations in the UK and the Netherlands demonstrate a preference for ends commands\footnote{C. Coglianese and E. Mendelson, “Meta-regulation and self-regulation” in R. Baldwin, M. Cave and M. Lodge (eds), \textit{The Oxford Handbook of Regulation} (Oxford: OUP, 2010), 146.}—the primary focus is on accurate and complete tax returns as the outcome of the regulatory process. However, with the introduction of the SAO legislation and the requirement for large companies to publish their tax strategy, HMRC in the UK demonstrate a move towards the use of means standards.

Another similarity with meta-regulation is the emphasis that HMRC and the NTCA put on the ability of companies to think reflexively about their fiscal control structure. Both tax administrations reflect the preference emphasised in meta-regulation to prevent overregulation, and to use the knowledge and expertise of those being regulated, here taxpayers. While this method has contributed to an improvement of companies’ tax function, this article demonstrates
that in practice reflexivity, and its potential advantages, are more challenging to achieve than was expected at the outset of the CC-based working relationships. Due to capacity issues, companies with a weak tax function receive limited support in practice to help them reflect upon their TCF, which undermines the ability of companies to improve their TCF. This problem is more substantial for the NTCA than it is for HMRC, as the NTCA’s risk assessment strongly relies upon corporate self-assessment and hence requires highly developed reflective skills. Although the NTCA faces increased pressure to issue more specific guidelines as to the design and implementation of TCF’s, it is challenging for the Dutch tax administration to meet this demand given the relatively large number of corporate taxpayers participating in Dutch CC, leading to highly diverse corporate tax profiles. With risk profiling in the UK being more tightly restricted to the category of large corporates, inter-company differences amongst UK companies being risk assessed are fewer compared to their Dutch counterparts, thereby enabling HMRC to issue more specific guidelines on how corporates may improve their tax control systems.

One of the chief attractions of meta-regulation is the discretion it affords to those being regulated, which is assumed to improve the efficiency and effectiveness of the regulatory process. Clearly, these benefits may be difficult to realise in the context of tax administration. This is partly because tax officials struggle to adjust to the new supervision model, with some of them continuing to interact with companies by using a traditional regulatory approach, reducing the capacity of companies to exercise discretion. Increased scrutiny of the tax behaviour of large corporates by media and politicians has led to a more cautious stand being taken by tax administrators operating in CC arrangements, a factor which appears to have diminished discretionary space for corporate taxpayers.

Another reason for the challenges posed by meta-regulation is that the level of transparency and openness demanded from companies and the tax administration in CC-type relationships requires substantial administrative capacity from both sides. Hence, the administrative demands put upon the meta-regulator can be substantial, which contrasts with the efficiency gains, widely expected in the literature, from implementing a meta-regulation approach. At the same time, however, corporate interviewees and their advisers, indicate that the real-time nature of CC-type relationships has significantly reduced their tax workload. Hence, the benefits of meta-regulation may be easier to identify for the taxpayer than for the tax authority. In both the Netherlands and the UK, real-time working has been combined with a significant reduction in audits carried out by the tax administration on corporates in a CC arrangement—either through joining a specific programme (the Netherlands), or receiving a low risk rating (UK). This demonstrates that, despite the differences in how risk assessments are being conducted, the outcomes of these processes for businesses perceived to be low risk are highly similar.

Due to its preventive and ex ante orientation towards tax compliance, it is in most cases impossible to specify the effects of CC regulation on the amount of taxes collected. In an era in which quantification has become the primary mechanism through which the effectiveness of public sector programmes is evaluated, CC programmes in both countries face credibility challenges. This demonstrates that even in a situation where meta-regulation would increase regulatory effectiveness, it might be more difficult to sustain organisational and societal legitimacy for meta-regulation compared to traditional regulation. These credibility issues will be more substantial when the CC-based relationships have (still) not been able to deliver clear efficiency
gains, a problem currently faced by both the Dutch and UK tax administrations. In addition, the continuing devotion of significant administrative resources to CC companies generates tensions about the allocation of resources within the tax administration, as well as among different categories of taxpayers.

The increasing use of data analytics allows the Dutch and UK tax administrations to increase their auditing efficiency in the large business domain. Although still at an early stage, successful implementation of data analytics might enable tax administrators in both systems to monitor compliance, not only by being able to better identify risks that potentially increase non-compliance but also by gathering intelligence on company features that strengthen compliance. This would enable tax administrators to be more confident when providing businesses with feedback on their risk management structure, and to develop risk management systems that more strongly reflect an “outside in” rather than “inside out” design.