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Conflict to Cooperation – Roadmap for tax dispute resolution



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Introduction

The integrity and efficiency of any tax administration system hinges upon the creditability of its dispute resolution mechanism in the eyes of the taxpayers. For a developing economy such as India, where the courts and tribunals are over-burdened with disputes from every aspect of life, it becomes imperative to have an efficient and cost effective tax system for the assessment and payment of taxes so as to relieve taxpayers from the burden of vexatious tax litigations and endless disputes, and equally provide them with suitable avenues for dispute resolution.

With the intention of achieving that goal, the government, in its proposals for 2016, emphasised encouraging use of an e-assessment procedure to make tax assessment proceedings objective and less time consuming and is up and running in seven cities, Mumbai, Delhi, Chennai, Bengaluru, Ahmedabad, Kolkata and Hyderabad. The approach of the government is therefore to shift the economy towards a ‘broad base, low rate’ taxation regime. The emphasis on ‘digital India’ and a ‘cashless economy’ must, therefore, be seen in the same light.

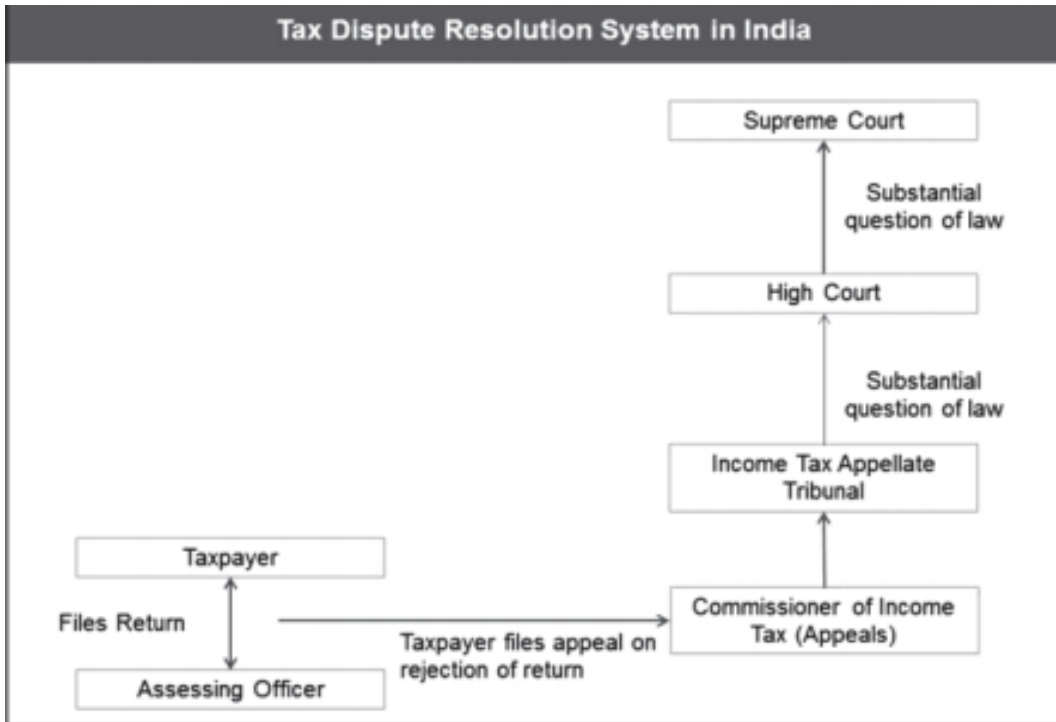
Recent times have witnessed continuous efforts of the tax authorities as well as the government to improve the image of India’s tax administration and tax collection, and moves are constantly being made along these lines. It is not an exaggeration to state that the Indian policy reforms are moving in a direction where India being viewed as an adversarial jurisdiction is removed over a relatively short period of time.

The chief concern of taxpayers, including multinational companies, that the tax authorities frequently adopt aggressive positions inconsistent with both international and domestic taxation norms and principles, has also been addressed by the current administration, and ensuring the ease of doing business remains the underlying objective of the government in all the policies it is formulating.¹

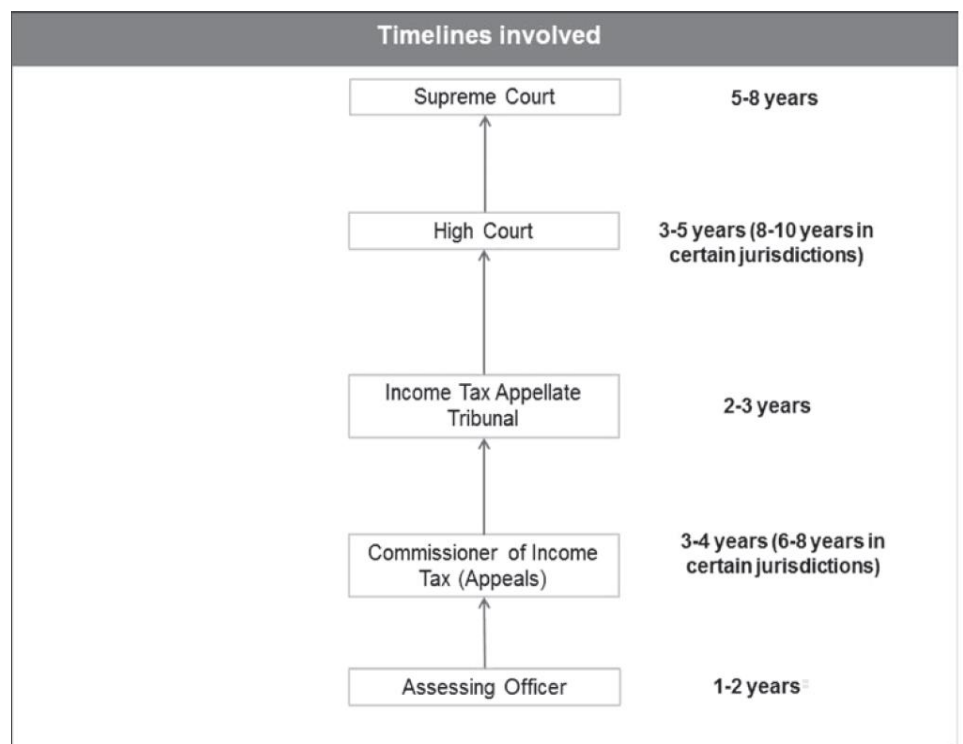
¹ The tax disputes and litigation review – edited by Simon Whitehead, Law Business Research Ltd.
<https://thelawreviews.co.uk/edition/the-tax-disputes-and-litigation-review-edition-6/1167712/india>

Existing Framework

Under the current scheme of the Income Tax Act 1961 (Act), various remedies are available to a taxpayer, when he or she is aggrieved by the action or order of an assessing officer (AO): appellate, administrative and writ remedy, alternative dispute mechanism, and advance rulings and APAs.



Although time limits are prescribed for completion of assessment and for each level of appeal, such time limits are rarely strictly followed. As per Indian Chambers of Commerce and Industry the average time take at each stage is as follows:



Less is more said the Economic Survey when it comes to appeals by the income tax department for both direct and indirect tax cases.

Faced with a success rate that is less than 30%, the Survey said the tax department would gain from a reduction in appeals pursued at higher levels of the judiciary besides leading to a reduction of workload on high courts and the Supreme Court.

4.7% of GDP

In March, 2017, there were approximately 1.37 lakh direct tax cases and 1.45 lakh indirect tax cases under consideration by the Income Tax Appellate Tribunal, high courts and Supreme Court.

“Together, the claims for indirect and direct tax stuck in litigation by the quarter ending March, 2017, amounted to nearly ₹7.58 lakh crore, over 4.7% of GDP,” the Survey said.

The tax department is the largest litigant with almost 85% of direct tax cases arising out of its appeals. But the Survey pointed out that, “the Department unambiguously loses 65% of its cases”.

Current Tax Dispute Resolution Framework

The mechanical application of laws, arbitrary tax demands and protracted litigation coupled with the aggressive stance taken by the revenue department in the past has made India infamous for its adversarial approach, which drew criticism to such an extent that India was perceived as a non-tax friendly jurisdiction. However, the government has advocated the need for a non-adversarial tax regime, with the focus shifting towards enhancing efficiency by reducing the burden of compliance.

In addressing these concerns, a number of worthwhile measures have been undertaken to encourage a non-adversarial tax regime and to fuel growth. For example, several departmental office instructions have been issued with the overall aim of building capacity, improving the quality of assessments and encouraging the e-assessment procedure; and regarding the decision to not to pursue specific issues before the Apex body, etc., apart from the ratification of a mutual agreement procedure (MAP), and the entering into of unilateral or bilateral advance pricing arrangements (APAs) to bring clarity to the transfer pricing regime.

On the other hand, the stringent Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act 2015 has also been enacted with the objective of preventing income and assets from being illegitimately kept outside the purview of the Indian tax net.

In terms of dispute resolution mechanisms, India already has in place an elaborate structure of dealing with tax disputes. However, the perspective on dispute resolution needs to be re-evaluated with a focus on the psychology of the taxpayer.

Psychology of the Taxpayer

Many aspects of observed human decision-making differ from the 'rational' behaviour assumed in economic models.

- People are much more concerned about possible losses than possible gains
- People are inclined to stick with the status quo
- People dislike uncertainty
- People value fairness
- People sharply discount the future compared to the present

This combined with the complexity of the tax provisions largely limits the way in which people make decisions with respect to tax.

Tax Compliance = taxpayers' willingness to pay their taxes.

Different forms of compliance:

- **committed compliance** is taxpayers' willingness to pay their taxes without complaints;
- **capitulative compliance** refers to reluctantly giving in and paying taxes;
- **creative compliance** is engagement to reduce taxes by taking advantage of possibilities to redefine income and deduct expenditures within the brackets of the law.

Layman's Perception of Taxation



Taxes are perceived as

- a loss of personal freedom to decide how to invest one's own money,
- as contributions without a fair return, or
- as a repeated request by the government to fill the gaps in the state's finances caused by inefficient management by politicians.

Entrepreneurs perceive tax as:

- punishment and disincentive to work,
- public constraint,
- a lack of clarity in tax law and public use of taxes,
- complex bureaucratic rules as a form of pressure and a hindrance to work
- bureaucratic laws and rules are too complex and that fiscal policy is unclear.

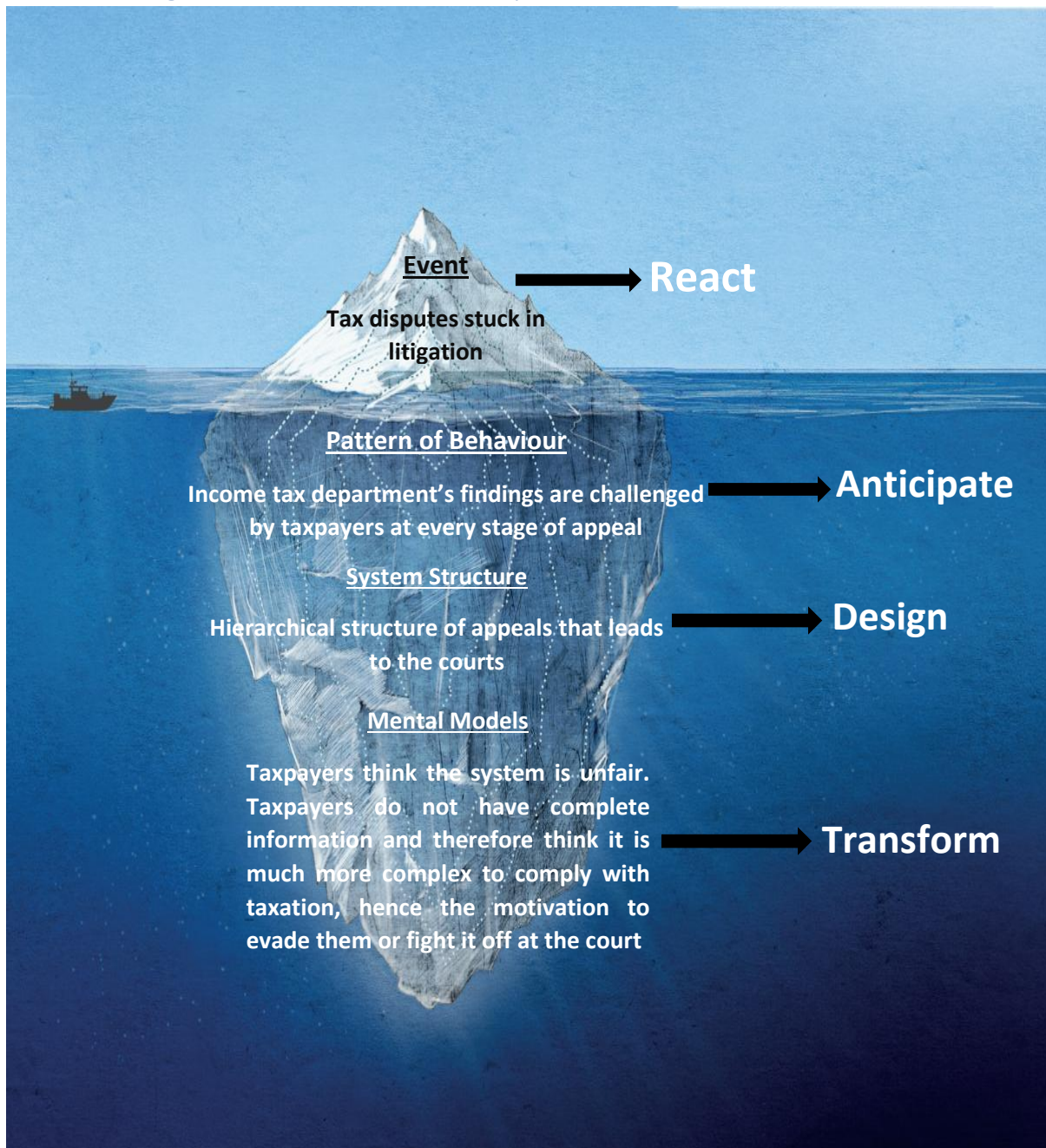
Social Representation of Taxes

- cultural standards, often mirrored in the actual law.
- Studies attribute national differences in tax compliance to different norms and to different stages in the development of institutions and citizens' varying trust in the government.
- In the post-reunification period in Germany, inhabitants of East Germany had stronger norms to comply than those of West Germany, but also that the norms and tax morale in the East seemed to erode over time.

Rather than responding to non-compliance by intrusive audits and severe punishment, supportive communication and interaction inspiring trust as well as appeals to cooperation will encourage compliance.

Given all the above information the desirable initiative should be to adopt a policy measure that has an impact on the psyche and perception of the taxpayer. The dispute resolution mechanisms should be designed in a such a manner that it does not reinforce the same pattern of behaviour or conflict. The cycle of conflict starts because the taxpayer believes that the authorities misunderstand or misconstrue the findings related to his/her income. Hence the taxpayer keeps on trying the channel of appeal till he/she obtains relief. So, now that the problem has been identified the remedial measure needs to be taken care of.

The Iceberg Model of Taxation Dispute



The iceberg model in the System Dynamics framework is unique in its construct as it allows us to delve deeper into the policy issues.

The event level is the level at which we typically perceive the world. While problems observed at the event level can often be addressed with a simple readjustment, the iceberg model pushes us not to assume that every issue can be solved by simply treating the symptom or adjusting at the event level. At first the events that we see around us make us only react to them. Like India has a lot of tax disputes that invariably lead to litigation which results in loss of time, money, and effort. This is an event which will lead us into reacting. Our reaction will be to expand our current infrastructure to accommodate the number of conflicts. However this is definitely not a long term solution and would not effectively clear the backlogs.

If we look just below the event level, we often notice **patterns**. Similar events have been taking place over time. Observing patterns allows us to forecast and forestall events. Since the pattern of behaviour is challenging the decision at every level, it indicates a pattern of cases where an appeal is most probably expected and courts can accordingly set aside cases which may or may not require their intervention. However the courts will still have an enormous amount of cases coming their way. Moreover the trend is also that the Income tax department loses most of the cases that go to the court in appeals.

Below the pattern level lies the **structure level**. When we ask, “What is causing the pattern we are observing?” the answer is usually some kind of structure. The structure in this case is the elaborate system of appeals which at every turn gives the opportunities to the taxpayers and tax authorities to move to higher structure of appeal when the decision is not in their favour. The intervention needs to be at this stage. This can be done by inserting a mechanism at an early stage which discourages litigious attitude.

Mental models are the attitudes, beliefs, morals, expectations, and values that allow structures to continue functioning as they are. These are the beliefs that we often learn subconsciously from our society or family and are likely unaware of. As we have discussed earlier that the taxpayer’s perception of tax and tax morality is shaped by the society. There is a lack of trust and cooperation between citizens, corporate/business sector and the Government. At present the general perception is mutual suspicion among all three. The Government and citizens suspect that corporate business is dishonest and accumulating profits at their cost. The private sector and citizens suspect that the Government does not use their tax collection for general welfare of the society and taxes are wasted.

By bringing in policy measures that target the mental model will result in transformation. Mechanism will have to be developed which shall lead to an environment of trust, whereby individuals will be encouraged to pay taxes as they will be convinced of the concept of taxes.

System Structure

The system structure can be made more efficient in two ways:

- 1) Introducing mediation as an alternative dispute resolution mechanism when the taxpayer challenges the assessing officer's findings.
- 2) Introducing an efficient mechanism of computation and collection of taxes which reduces the scope of conflict itself.

Cooperative Paradigm In Relating Taxpayers And Tax Authority

OECD (Organizational for Economic Cooperation and Development) and UN have supported their members to establish an international tax system, to avoid tax dispute among them and to solve the dispute, if it occurs, as soon as possible. In order to reduce conflict escalation, to improve their relationships with taxpayers and consequently to enhance voluntary compliance, there has been a recent trend by revenue authorities internationally in employing different initiatives, including alternative dispute resolution process without litigation. Two countries which have adopted cooperative paradigm to enhance the relationship are Australia and UK. Cooperative compliance is able to solve tax administration problems in developing countries. It is also able to create a compliance among taxpayers effectively and efficiently.

In 2013, OECD issued the idea completed with its background on the importance of the relation between taxpayer and tax administration using cooperative relation. The tax administration made by the country is expected not only through law empowerment but also through taxpayer service improvement. Recently, HM Revenue and Customs (HMRC) in the United Kingdom (UK) and the Australian Taxation Office (ATO) in Australia become two revenue authorities which have adopted various forms of in-house facilitation processes following the conduction of pilot trials

International Case studies

United Kingdom

Tax institution in UK, Her Majesty's Revenue and Customs (HMRC), in 2011 tried to make a dispute settlement program using Alternative Dispute Resolution. The first program is to provide ADR for big scale companies and taxpayers with complex tax problems. ADR process involves independent third party called mediator (accredited mediator). The second program is intended to provide ADR for Small and Medium-Sized Enterprises and individual taxpayers (SMEi). On the process of ADR, particularly SMEi, HMRC offers trained facilitators to resolve disputes (without involving mediators). In the mediation and facilitation programs of the tax dispute resolution, HMRC involves the neutral third

parties such as mediators and facilitators. Recently, the program has been considered successful and numerous used to overcome the cases of individual taxpayers and small and medium-sized enterprises. However, HMRC is more careful to employ the mediation in several big and more complex cases.

According to HMRC, the resolution using ADR is able to achieve the settlement through efficient cost, quickly (resolving disputes by agreement). **The way in which tax disputes are managed and resolved can have a significant impact on the overall experience that taxpayers may have in interacting with revenue authorities. This, in turn, can impact on taxpayer voluntary compliance.**

Australia

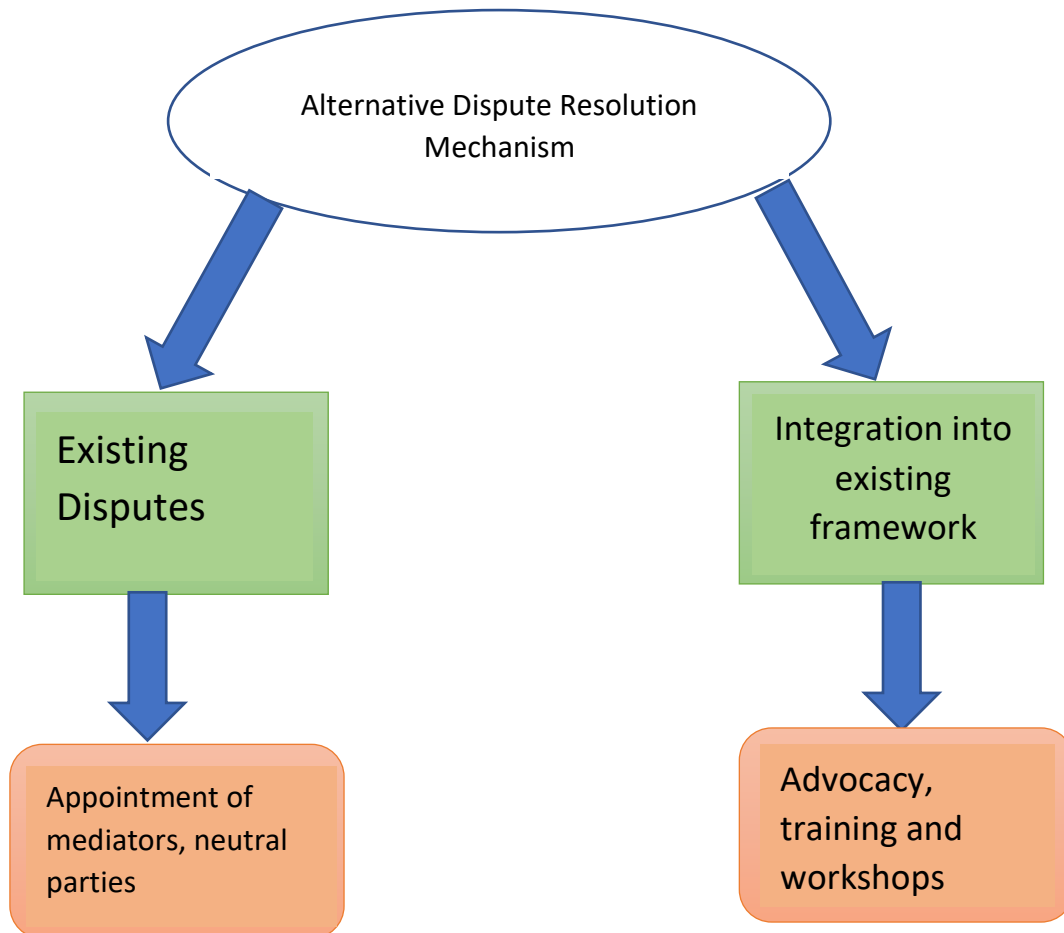
Australia commenced to use ADR by Australian Taxation Office (ATO) in 2013 to overcome tax disputes (involving mediation, negotiation, case discussion, conciliation, evaluation by neutral parties). ATO has developed strategies and big changes on the culture of tax dispute resolution in Australia. This was conducted after the presence of recommendation from OECD to improve the relationship with taxpayers. After the recommendation, ATO subsequently issued Practice Statement Law Administration PS LA 2013/3, Alternative Dispute Resolution (ADR) in ATO disputes. The regulation contains guidance and principals to apply ADR. The regulation has provided ease for the taxpayers to cope with tax disputes easily, cost-effectively and quickly. The regulation of ADR set up by Australia has shown efforts to improve better relationship with taxpayers. This is seen from the provision explaining that the relationship between ATO and taxpayers may not end due to conflicts or disputes, as described as follows:

Most taxpayer interactions with the ATO do not end up in dispute. When disputes occur, the ATO prefers to resolve them as soon as possible at minimal cost to the parties. Most disputes are resolved quickly and informally through direct ways.

Conflict to Cooperation: Way Forward and Suggested Framework

The alternative dispute resolution mechanism for the tax disputes needs to have a two pronged approach. The first approach is corrective in nature which shall be applied in the existing disputes in a phased manner. The second approach shall be preventive measure to incorporate the culture of ADR in the existing framework.

Two pronged approach for ADR integration in the existing framework



The ADR approach aims to create a win-win situation for the conflicting parties. Since most of the cases that go for appeals in courts are lost by the Income Tax department and let's face it, even the taxpayer does not have huge win given the efforts, time and money invested in fighting it out in the court. ADR will help convert this lose-lose into a win-win.

The advocacy and training will help reinforce the framework of ADR within the existing system structure. Campaigns and active advocacy shall help put forward government's stance on taxation and its policies. At the same time these efforts will also be utilised to educate the general public on the matters of taxation so that they can take informed decisions and feel a part of the process. Since the objective is to induce a behavioural change by altering the mental model it is going to be a long term process that will have to be complimented by the short term changes in the system.

Achieving Tax Compliance through Technology

The crux of the tax dispute lies in the taxpayer not complying with the tax regime due to the complicated tax framework which incentivises this behaviours of tax evasion. What if we place a technology that removes these barriers of tax collection and makes compliance automated? The answer is Blockchain.

Tax professionals should be aware that blockchain technology has the potential to revolutionize the taxation of transactions as well as their record-keeping, but we believe the technology even has the potential to automate many processes within the transfer pricing world.

The single achievement of blockchain technology is enabling the secure transfer of digital assets without a central authority, bank or any other mediator between the two parties to a transaction. A peer-to-peer network of computers equipped with cryptographic algorithms examines each new transaction, comes to a “consensus” about its validity, and either validates or rejects it. A nearly real-time record of transactions taking place through the network is visible to all participants, achieving unprecedented transparency.

Three types of blockchains

- **Public blockchains** such as the ones that host cryptocurrencies require tremendous processing power.
- Companies wanting a smaller network create **private blockchains**, granting permissions to participants: read only, limited transactions, etc., as in a traditional corporate database. Notice that the company must re-introduce the central authority itself, but still benefits from blockchain’s unique accuracy and transparency, potentially also permitting real-time auditing by regulators.
- Finally, there is the **consortium blockchain**, common in banking, which may grant reading rights to many people or even everyone, but which limits the consensus mechanism to a few trusted parties, achieving faster processing.

All three blockchain types support “smart contracts,” computer programs that self-execute the terms of an agreement when predefined conditions are met by transacting parties, greatly reducing or eliminating the costs of coordination, monitoring and enforcement. This is one of the features that differentiates a blockchain from a traditional database or an enterprise resource planning (ERP) system.

A multitude of blockchain applications is springing up and governments are thinking that blockchains can help address some of the challenges of taxing the digital economy. Estonia, Luxembourg, Singapore and India are among the first movers, and developing countries hope blockchain technology can help them leapfrog more-developed economies.

Potential applications for transfer pricing

Given the characteristics of blockchain, it's not surprising that tax professionals are intuitively accepting the idea that value-added taxes (VATs) and other transaction taxes are candidates for management on a blockchain.

Considering the complexity of intercompany transactions and governments' demand for transparency, automating the processes of applying, documenting and defending transfer prices is clearly attractive,

There is no reason a multinational enterprise (MNE) could not reliably use blockchain to track its intercompany transactions and to make payments according to pre-established, arm's-length conditions via smart contracts, when the necessary conditions are met. Intangible assets could be tokenized, with a token representing the entire intangible asset or a defined fraction of it.

This could prove especially valuable for transactions involving shared asset ownership, cost contribution arrangements and the application of profit split methods. Companies could also use blockchain technology to optimize intra-group treasury transactions including intra-group current accounts, cash pooling, other types of lending transactions and guarantees, among others.

If a company's vendors and customers are also invited to join a private blockchain, it can track and display an entire supply chain, complete with documentation and real-time visibility of all its transactions. It's even possible that with blockchain's increasing adoption, new sources of bigger and better data will enable a more frequent application of the comparable uncontrolled price method for establishing arm's-length prices between MNEs and their subsidiaries and related groups.