Dutch Enforcement Covenants, Mutual Trust and Fair Share

Richard Happé*

1 Introduction

In this paper I will examine a typically Dutch compliance instrument: the enforcement covenants that the Dutch Tax and Customs Administration (*Belastingdienst*, hence TCA) concluded with multinationals at the end of 2005.¹ The conclusion of these agreements is part of a long tradition of consultation in Dutch tax practice, and in that sense is a modern example of the unique Dutch consensus or *polder* model. Although it is still too early to say whether these agreements have been a success, they are an unconventional, almost revolutionary method of exerting a positive effect on and supporting multinational compliance, entailing horizontal supervision embedded in a vertical supervision framework. In essence they are an invitation to mutual trust.

I will propose the *conditio sine qua non* for such agreements: enterprises must feel obliged to pay their fair share of tax. An invitation to mutual trust by national tax authorities must be counterbalanced by a willingness on the part of the private sector to acknowledge its fair share. If both tax authorities and the business community can agree on this point, then a foundation for cooperation exists in which both sides respect each others’ interests. In order to provide a better grip on the matter I will further operationalise the fair share idea in two ways. Here the Aristotelian ’virtue’ ethic of choosing the ‘appropriate’ mean could prove useful.

2 Tax version of the *polder* model: Enforcement covenants

The Netherlands is known for its culture of consultation. The Dutch *polder* model, or dialogue between government and major civil society organisations that is aimed at consensus, has acquired international renown. The Dutch government and its citizens are well aware of the fact that they depend on each other to accomplish great things. The underlying culture of consultation runs in the blood of the Dutch. And this certainly applies to taxes. One of the strengths of the Dutch Tax and Customs Administration (*Belastingdienst*, hence TCA) is its willingness to conduct a dialogue with taxpayers and make arrangements. A current manifestation are the enforcement covenants, the essence of which is the relationship they define between the TCA and a multinational. In mid-2005 the State Secretary of Finance made his aim clear: he wanted horizontal supervision. He announced a pilot scheme with about twenty enterprises, most of them listed. His idea was to have Management Boards and tax inspectors conclude individual enforcement covenants on a voluntary basis. In this way he envisaged increasing legal certainty for the corporations and avoiding devices normally combated through vertical supervision. At the end of 2006 the Minister of Finance reported that covenants had been concluded with nearly all twenty corporations, and that the pilot scheme had been extended to include another twenty. It is said that at the moment approximately 37 corporations have an agreement. Only a few are said to have declined to conclude an agreement. In the meantime, under pressure of the Lower House an anonymised covenant has been published.

* Professor of Tax Law, University of Tilburg, The Netherlands, e-mail: R.H.Happe@uvt.nl. This paper is based on “Multinationals, Enforcements Covenants and Fair Share”, which will be published in Intertax.

¹ The TCA itself refers to listed or very large enterprises. For the sake of simplicity I generally refer to these enterprises as multinationals.
What do these enforcement covenants actually entail? One aim of the covenants is to significantly limit the TCA’s vertical supervision activities. Reduced vertical supervision means that available capacity can be deployed to deal with other, less compliant, taxpayers. Also the interests of the multinational lie first and foremost in reducing vertical supervision. Less far-reaching audits mean reduced administrative burdens.

Another interest of the multinational lies in the prospect of rapid action on the part of the tax inspector. Past tax disputes are settled, while matters of the present and the future can be put to the inspector so that he or she can take a stance on them, thus increasing legal certainty. This is also based on the premise that the law is applied and that no more or less favourable stances are taken. It makes clear that these enforcement covenants deal primarily with the inspector’s discretionary powers: the degree to which he draws upon his powers of control and the pace at which he tackles the implementation of tax legislation.

Finally, another important premise is that corporations report actions that have a bearing on tax openly and in good time. This leads us to the next section.

3 Transparency of information and voluntary reporting of tax risks

One of the biggest problems faced by the tax authorities in trying to implement tax legislation properly is a lack of transparency of the taxpayer’s information. Vertical supervision in the form of audits is therefore an essential means of obtaining the information required. On the other hand, the covenant is explicitly based on transparency. The parties to it agree to be open about their dealings. In conformity with the published covenant the multinational undertakes not only to report all actions that involve tax risks, it also consents to disclose its views about the legal consequences of such actions and the positions taken by it. This goes beyond its actual statutory obligations. Based on the Dutch General Taxes Act, the taxpayer is only obliged to provide factual information. The covenant therefore entails voluntary reporting of tax devices, regarding which the United States and United Kingdom, for example, have increasingly introduced statutory disclosure obligations.

The question is whether the term ‘tax risks’ referred to in the covenant is not too vague. There is no doubt that this term includes abuse of law practices. Nevertheless, an assessment margin always applies here: one person’s idea of aggressive tax planning is not necessarily another’s. Where, for instance, does the search for the most favourable tax arrangement end in the evasion twilight zone?

In my opinion, the obligation to report ‘relevant tax actions’ is inherently too diffuse to be left simply to the multinational. The mutual financial interests at stake are too great. Finally, there is always the risk of some corporations being unable to resist the universal, age-old temptation to ‘play the audit lottery’. This would obviously jeopardise the continued existence of the enforcement covenant. It would also have undoubted consequences for actual vertical supervision of the multinational in question. In this context the Dutch Minister of Finance has given a warning: a multinational which violates the covenant, will be dealt with more severely than in other situations in which no covenant had been concluded. This last point again underlines the fact that given such a situation the TCA should lay down a clearer definition of the term ‘tax risks’ before concluding an enforcement covenant. Right now it seems that its definition is left too much to the multinationals.

Furthermore, it is also necessary that compliance with the undertaking to report tax risks is subject to vertical supervision. In this sense the omission of vertical supervision makes meta-vertical supervision of horizontal supervision necessary. In turn the assessment of such meta-supervision can finally clarify whether voluntary reporting works satisfactorily, thus rendering superfluous a statutory obligation to report.
4 Enforcement covenants: The basis is mutual trust

What is clear therefore is that mutual trust is the essential element of these covenants. Based on it both parties take heed of each others’ interests. Conditional upon their cooperation with one another is reciprocity. When can mutual trust be said to exist? Under what circumstances is a tax authority prepared to reduce its vertical supervision significantly? Important factors in answering these questions are the trends both among tax authorities and multinationals. In any case after the scandals of Enron, WorldCom and others a number of multinationals have realised that tax risk management forms a crucial part of their corporate governance policy. Tax risk management thus implies that the multinational is expressly aware whether and to what degree it behaves as a compliant taxpayer. Some multinationals even go a step further, incorporating such management into their policy on corporate social responsibility. It is also in that context that the issue of contributing a fair share of tax is one that keeps surfacing. Over the last two decades tax authorities have also undergone a major development. Their actions are currently shaped to a large extent by risk management and compliance strategy. This means in particular that tax authorities adopt an approach that corresponds to the degree of compliance on the part of the taxpayer. Multinationals who behave compliantly are entitled to expect the tax authorities to show a corresponding attitude.

What makes tax authorities and multinationals conclude cooperation pacts with one another? A prerequisite is that the multinational behaves as a compliant taxpayer and that the tax authorities recognise this behaviour as such. A further requirement is that the multinational subscribes to the idea of fair share, and practices it as well. Acknowledging this necessity is, in my opinion, the *conditio sine qua non* for concluding an enforcement agreement. Only if both conditions, which are linked to each other, are satisfied is there room for mutual trust and can the parties really take heed of each others’ interests. And only on the basis of such trust can there be, as John Rawls puts it, a ‘cooperative venture for mutual advantage’.\(^2\) If the TCA does not have this fundamental trust in the willingness of a particular multinational to pay its fair share of tax, then no covenant should be concluded. Likewise, a covenant or arrangement should be terminated if this fundamental trust is violated. The Dutch enforcement covenant presupposes this fundamental idea of cooperation with taxpayers based on trust. It can only be a meaningful compliance instrument if the taxpayers in question feel their obligation towards society to pay their fair share of tax. An important touchstone for them is actual transparency. Taxpayers agree to be open about their tax planning for commercial operations, while the tax authorities are transparent in taking stances on those operations.

This brings up a very important matter: is the TCA not too trusting? It cuts back its vertical supervision, trusting the multinationals to take their interests seriously as well. It explicitly places its trust in the other party. No specific conditions must be met by the multinational. For example, no due diligence verification is carried out by the TCA, while no demands are made concerning the level of the multinational’s tax risk management. Also the other arrangements deal primarily with the parties’ expectations of one another. The enforcement covenant is a cooperation pact rather than a legal agreement. The critical factor here is that if a multinational’s effective tax burden is low, its financial interests are very high. This makes it all the more important how the multinationals in question deal with the issue of their fair share.

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5 Fair share and Aristotle’s doctrine of the mean

Is it possible to provide more substance to the idea of fair share? In order to do so we must first of all point out the intrinsic relation between a modern society and the payment of tax. This also goes for multinationals. The success of a market is wholly dependent on the degree to which the legal system, financed by taxes, provides effective legal protection. Murphy and Nagel point out that ‘the modern economy … would be impossible without the framework provided by the government supported by taxes’. The idea of a just society is also important here. Citizens of a just society are entitled to equal fundamental rights. In many countries, the obvious expression of this is the Constitution, which lays down fundamental rights. In this context the obligation to pay tax qualifies as a fundamental duty of every citizen. Murphy and Nagel point out that ‘the modern economy … would be impossible without the framework provided by the government supported by taxes’.4

The idea of a just society is also important here. Citizens of a just society are entitled to equal fundamental rights. In many countries, the obvious expression of this is the Constitution, which lays down fundamental rights. In this context the obligation to pay tax qualifies as a fundamental duty of every citizen. Murphy and Nagel point out that ‘the modern economy … would be impossible without the framework provided by the government supported by taxes’.5 This view is allied to the idea that everyone pays his fair share for the costs incurred by society. In that sense everyone’s tax contribution is an expression of respect for society and fellow citizens. The multinational that acknowledges this and thus respects and performs its fundamental duty to pay tax occupies common ground with the TCA in concluding an enforcement covenant.

What does this mean for the multinational’s actual tax behaviour? Here Aristotle’s doctrine of the mean may be useful. Following serious reflection, virtue in terms of taxation is a matter of making a properly considered decision about one’s own tax behaviour. This means that the wise multinational chooses the mean between two extremes: on the one hand the unadulterated pursuit of its own interests by means of aggressive tax planning and, on the other, giving absolute priority to the interests of the community in which the company operates. Neither extreme shows evidence of practical wisdom. This implies on the one hand that there is a limit to the tax adage that everyone is free to opt for the cheapest solution. After all, virtually anything is possible under tax law. Escaping tax altogether or, if this is not possible, postponing it, sometimes seems to be the only motive. This concept of tax as a mere tool deprives tax law of its legal character, its purpose and its justness. After all, membership of a society means not only that everyone gets his own allotted share, but also that everyone does his own bit. Good tax judgement thus entails a certain amount of restraint regarding that which is technically possible. A guide to employing tax devices should thus be that one should not only adhere to the letter of the law, but also feel bound at all times to its spirit. Daniel Shaviro put it as follows: ‘The management and shareholders should act in the interest of taxpayers generally by confining their pursuit of self-interest in tax minimisation to strategies and reporting positions that are reasonably within in the spirit of the law’.8

A more general perspective for determining whether a multinational takes the fair share idea seriously is offered by examining the effective tax burden it bears. This may give a first clue about the degree to which the multinational actually observes the fair share idea. In other words, it is also the effective tax burden that indicates to what extent the multinational chooses the correct mean. This is not the case, for example, with multinationals that have

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6 See Aristotle, Ethica Nicomachea, 1111 b 5.
7 Aristotle, Ethica Nicomachea, V. See also Digesta, 1.1.10, Dublin/Zurich: Weidmann, 1966.
reduced their tax burden to nil or very nearly nil. But on the other hand it is not necessary to put aside one’s own interests entirely and pursue a tax policy that is most beneficial to the government. The fact is that corporations aim to maximise profit. The matter at issue is that they also take into account their social responsibility. John Braithwaite rightly remarks that ‘[t]ax integrity means paying the right, the just, amount of tax, not the maximum amount’.9

If a multinational employs aggressive tax planning or endeavours to minimise its effective tax burden, then intensive vertical supervision is necessary. This leaves no room for an enforcement covenant. The fundamental condition for an enforcement covenant is after all the willingness of the multinational to observe tax restraint and contribute its fair share to society. This fair share notion serves as a corrective to the unbridled pursuit of a multinational’s own interests. To quote Aristotle, ‘[a] temperate human being … holds a position between these things.’10

6 Summary

In summing up I repeat some of the most important conclusions above.
- 1. In 2005 the TCA extended a remarkable invitation to mutual trust, in the form of the enforcement covenant. It thereby demonstrated its willingness to make arrangements with multinationals reducing its vertical supervision and undertaking to work in the here and now. In return multinationals are required to operate transparently and report tax risks openly and in good time. Based on mutual trust, the parties pay heed to each others’ interests. A crucial factor is the duty to report ‘tax risks’. In recent years a number of other countries have introduced a statutory obligation to report. In the Netherlands, multinationals report voluntarily within the framework of a covenant. In this context vertical supervision is still indispensable. The term ‘tax risk’ is too vague to have its application left entirely to the multinational. A clearer definition is required from the TCA. It also creates a responsibility on the part of the TCA for the proper legal application of ‘meta-supervision’ of covenant compliance.
- 2. Enforcement covenants are a modern manifestation of the compliance strategy. In a certain sense they replace mistrust with trust. Both parties undertake to cooperate with each other with a view to each others’ interests. This involves a fundamental step on the part of the tax authorities, which to a large extent substitute trust for vertical supervision. For this to happen two conditions must be met: not only must the multinationals in question be compliant, they must also subscribe to the notion of contributing their fair share of tax and actually do so in practice. This element can be seen as a conditio sine qua non for such arrangements.
- 3. Whether the TCA is too trusting is irretrievably bound up with the way in which multinationals put the notion of fair share into practice. The contribution of a fair share of tax can be further operationalised on two levels. Here the Aristotelian doctrine of the mean is useful. On the level of actual tax devices, wisdom dictates a certain amount of restraint in exploring what is possible under tax legislation. Not only the letter of the law but also its spirit must remain recognisable. The second level is that of the effective tax burden. A multinational that succeeds in reducing its effective tax burden to nil or nearly nil cannot be viewed as a suitable party to an enforcement covenant. On both levels aggressive planning must be avoided. The point is to maintain a balance, Aristotle’s mean.
- 4. Finally: with the enforcement covenant the TCA has taken a ground-breaking initiative. It involves an unusual, innovative form of supervision. It provides both the TCA and

multinationals with the opportunity to take into account each others’ interests on a basis of mutual trust.