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ENHANCED RELATIONSHIP PARTICIPATION INCENTIVES FOR (DUTCH) MULTINATIONAL ORGANIZATIONS

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ABSTRACT

This paper deals with enhanced relationship participation in an international context. The purpose of this study has been to offer insight into the essentials for implementing a Tax Control Framework (TCF) and identify organizations' incentives to participate in an enhanced relationship. First, the common guidelines for implementing a TCF are described. Second, we investigate organizations' incentives to participate in an enhanced relationship on the basis of a survey conducted among the tax directors of the largest Dutch multinational organizations quoted on the Dutch stock exchange. Our analysis identifies two important incentives for organizations to participate in an enhanced relationship.

JEL: H20, H25, K34

KEYWORDS: Controlling, Corporate Governance, Enhanced Relationship, Tax, OECD, Internal Control

INTRODUCTION

As a result of an initiative of the Organisation for Economic Co-operation and Development (OECD), both tax compliance and tax accounting have undergone radical changes in most countries worldwide. Communiqués published by the OECD stimulate the implementation of risk-concentrated tax regulations aimed at "enhanced relationships". The objective is that companies organize their tax structures in a risk-oriented manner (OECD, 2010) in compliance with the overall internal control systems emphasized after the Enron failure. These tax structures should increase tax authorities' insight into companies' largest tax risks. Following the OECD initiative, countries all over the world have integrated enhanced relationship policies in their national regulations (Bakker and Kloosterhof, 2010). In 2005, the Dutch tax authorities introduced a version of the OECD's tax-based regulation called "horizontal monitoring".

As from the year 2007, horizontal monitoring has been the official policy in the Netherlands (Belastingdienst, 2008; Van Daelen and Van der Elst, 2010). Horizontal monitoring has changed the relation between the tax authorities and businesses. On the one hand, the tax authority has to stimulate an environment of trust and close cooperation. In return, the companies are expected to contact the tax authorities whenever there is ambiguity about their tax obligations. The advantage of this approach for the tax authorities is a better allocation of resources, as they obtain more information about which organizations and/or parts of organizations run the highest perceived risks. The advantage for companies is a less intensive tax investigation by the tax authorities at the year's end (Kemp and Verbakel, 2010). To achieve these benefits, however, the Dutch tax authorities need more insight into the risks of companies. To this end, they have obliged companies who want to participate in the "horizontal monitoring" system to set up a Tax Control Framework (TCF).For the ease of reading in this paper, the term "enhanced relationship" is used when the Dutch form is referred to.

However, although the OECD offers some general guidance, support in implementing a TCF is limited in the Dutch context; the Dutch Tax Authorities have no mandatory framework. However, there are well known models available used in controlling process other than those in the tax domain, for example COSO and COBIT. A TCF model which fully covers the requirements of the OECD, COSO, COBIT and the Dutch Tax Authorities is the Tax Management Maturity Model (T3M). This model categorizes tax risks into six specific tax-related subjects: Business & (Tax) environment, Business operations, Tax Operations, Tax Risk Management, Monitoring/Testing and Tax assurance. These broad areas are again divided into more specific factors which form the fundaments in judging a subject.

This paper focuses on the criteria for implementing a TCF and the main incentives of companies to participate in an enhanced relationship. First, TCF guidance will be explained. As a TCF has to cover the requirements as formulated by the relevant authorities, it is important to understand these rules. The question that will be answered is therefore: *What guidance should be offered by the OECD, Dutch tax authorities, COSO and COBIT in implementing a TCF?* Second, focusing on the practitioners in Dutch multinational firms, we will seek the answer to the following research question: *What are the main incentives for multinationals to participate in an enhanced relationship?* Here we will specifically emphasize three possible incentives: the effect on the business environment, new rules and policies in the near future, and the Netherlands as a tax haven. Below, we will continue with the literature review of this paper. The scientific relevance and the TCF guidance from the OECD, the Dutch tax authorities and the controlling models will be discussed. Finally, we present our analysis and the results of a survey conducted among Dutch multinationals quoted on the largest Dutch stock exchanges.

LITERATURE REVIEW

In this chapter we have performed a literature review. This review presents the state-of-the-art of the scientific status. Although enhanced relationships form a regular topic of discussion in the scientific literature (e.g. Simonis, 2008; De Groot and Van de Enden, 2010), the (international) guidelines for a TCF are only rarely discussed. However, tax controlling - and the TCF as part of it - is an important element in organizations' corporate governance. So, research on the implementation of a TCF is beneficial for both the controlling literature and the practical field. The benefits from a theoretical perspective have been discussed by Simone et al. (2013) and Hoyng, et al. (2009). In this paper a payoff model has been created to determine when there is added value from an enhanced relationship for both the taxpayer and the tax authority. This paper concludes that it's important for an enhanced relationship to be beneficial that the tax authority is able to identify uncertain positions with sufficient high probability and the cost of the program is sufficiently low. Companies strive to minimize the sum of expected taxes and tax-compliance costs. There is also (limited) literature from a government perspective: it was the OECD which introduced the concept of the enhanced relationship.

After years of discussion among the member states and numerous drafts, 35 economies signed the Seoul declaration in 2006 (OECD, 2006): a commitment to cooperation aimed at establishing efficient and international-orientated tax regulations. In 2008 this commitment was followed by the Cape Town Communiqué (OECD, 2008). Representatives of 45 economies discussed the application of risk management to taxes. More insight into companies' risk management practices would enable the tax authorities to allocate their resources more effectively to (parts of) organizations with higher risks (and less effective risk management) or companies without sufficient control over their taxes. In the years after Cape Town, the OECD provided the participating economies with some informative reports containing high-level input as regards the enhanced relationship approach (OECD, 2010; 2011; 2012). The main principles described in these reports included four aspects: real-time contacts with companies about tax issues, a focus on tax-related processes, making tax compliance easier, and stimulating a good cooperation between the tax authorities and the companies and their stakeholders.

The Dutch tax authorities obliged companies to implement a TCF for their enhanced relationship tasks. However, they offered only limited guidance in how to interpret this framework (Belastingdienst, 2008). The documentation published by the Dutch tax authorities mainly stated that practitioners had to develop a TCF on the basis of their own knowledge and experience. As a possible tool for the implementation of their TCF it was advised to use COSO. COSO (Committee of Sponsoring Organizations of the Treadway Commission) is a model developed to support companies in designing their internal control frameworks (COSO, 2004). It consists of four company goals, linked to four organizational levels and eight risk and control components. Besides the model, additional information is offered about best practices. For example, the COSO reports anticipate new challenges which companies are likely to encounter in the near future (e.g. COSO, 2009). So, applying the COSO model also requires the usage of the reports.

Information technology (IT) has a great impact on the functioning of most organizations. The processes concerning IT (IT governance) should therefore be sufficiently in control. A model which supports this purpose is COBIT (Control Objectives for Information and related Technology). It was developed by ISACA (Information Systems Audit and Control Association). COBIT consists of five fundamental principles: meeting stakeholder needs, covering the enterprise end-to-end, using a single integrated framework, enabling a holistic approach, and separating governance from management. In a practical context, COBIT has translated these principles into the four key areas ‘plan’, ‘build’, ‘run, ‘monitor’, and ‘governance’. Combining the guidelines described above from the OECD, The Dutch Tax Authorities, COSO and COBIT results in a framework for implementing a TCF. This framework can be easily implemented on an international level, as each country can combine its own national guidelines with guidelines set by the OECD, COSO and COBIT. As mentioned before an instrument, which fulfils the (international) TCF requirements, is the Tax Management Maturity Model (Colon, 2012).

The first important contribution of this paper to the literature is therefore that it has created a universal guideline for the development of a TCF. Above we presented the relevant guidelines applicable that should be combined for implementing a TCF. The Dutch focus of this paper could be easily changed to another context by replacing the Dutch tax law factors by those of another country.

The second important contribution of this study is the emphasis on practitioners. As an enhanced relationship cannot be entirely explained by theoretical concepts, practitioners are needed to contribute to the development of enhanced relationship policies. In this way problems will be recognized which are not detected when focusing solely on theories. To our knowledge there is only a limited amount of research on enhanced relationships which also includes practitioners (e.g. Freedman et al., 2009). The survey results as presented in this paper show some of the companies’ incentives for participating in an enhanced relationship. As the willingness of businesses to participate in such a relationship is essential for the success of the policies in this area, this paper has particularly concentrated on gaining insights into how to further implement enhanced relationship laws and regulations worldwide.

Data Gathering and Methodology

Next, we will present the findings of a survey conducted among the tax directors of a number of large multinationals. The results were further analyzed to find the most relevant incentives as indicated by these multinationals to participate in an enhanced relationship. But first we will rationalize the hypotheses which formed the input for our survey. After that, the analysis and results will be discussed. Research on enhanced relationships based on surveys is very scarce. To our knowledge the only relevant survey in this respect is that of Freedman et al. (2009). This study examines the UK practice. Because of the limited amount of relevant research on enhanced relationships, our hypotheses have partly been framed by (indirectly) related literature and common sense. As a result, it was not possible to add more relevant literature, since we did not consider work which was only remotely related as having any additional value.

Organizational goals are not only limited to the interests of the shareholders. Businesses have to consider the interests of all stakeholders. Corporate social responsibility (CSR) has an important impact on modern societies. Jones et al. (2009) define this concept as follows: the integration of social, economic, ethical and environmental considerations into the organizational strategy and operational activities. Transparency about taxes also forms part of this Corporate Social Responsibility. Societies differ in their strictness of CSR. These differences could be an incentive for organizations to settle in a specific country. Important here is the country's perception of CSR: does the society perceive the organization to perform its activities in line with the CSR guidelines? As regards taxes this issue could entail an in-control statement as part of the TCF (De Groot & Van der Enden, 2010). However, what is also important in this context is the company's perception. If companies consider an enhanced relationship as positive for their business, one could expect them to be more positive toward the inclusion of additional instructions in their TCFs.

Hypothesis 1: The perception that an enhanced relationship creates a better business environment is positively related to an organization's willingness to participate in such a relationship. Not every company employs the same level of CSR. Some are more prepared to be corporately and socially responsible than other organizations. Currently, companies are not obligated to engage in an enhanced relationship. However, if they expect the introduction of new compliance rules in the near future, they will have to think about how these regulations are going to impact their activities. This process of deliberation may render companies more willing to participate in an enhanced relationship immediately.

Hypothesis 2: The expectation of the introduction on an international level of an enhanced relationship policy in the near future (five years) is positively related to the willingness of businesses to participate in such a relationship. Some companies present themselves as being concerned with society as part of their CSR policy. If companies are expected to be more society-concerned regardless of the reputational effects and possible higher profits, they are also assumed to be more willing to pay taxes. Following this rationale, companies which believe that nowadays it has become too easy to avoid taxes should also be more willing to engage in an enhanced relationship, as it will enhance their reputation and make it better compared to that of relatively less paying companies.

Hypothesis 3: The perception of the Netherlands as a tax haven is positively related to the willingness of businesses to participate in an enhanced relationship. The assumed relations were tested by a survey held among a selection of companies. This selection was limited to Dutch multinationals quoted on the largest Dutch stock exchanges (AEX and Midkap). No difference was made in terms of industry or quotation on either only the Dutch or also on other stock exchanges. The Dutch multinationals quoted on the Dutch stock exchanges formed the most relevant sample, as the Dutch tax authorities generally initially focus on the these companies before imposing measures (such as enhanced relationships) on other businesses. The multinationals therefore had more experience with enhanced relationships than other companies in the Netherlands. For the companies selected, a survey was sent to these organizations' tax directors. The survey was conducted during the period March - May 2012. The operational data were extracted from the respective annual reports (2012). The sample contained 20 companies. We use two types of variables:

Dependent variable; The measure for the willingness to participate in an enhanced relationship was indicated by a value as given by the tax directors, scaled from one to five (one was no willingness and five the ultimate willingness).

Independent variables: The effect on the business environment was determined by questioning the respondents whether they considered an enhanced relationship to have a negative effect (one), no effect (two), or a positive effect (three) on the business environment. Whether the enhanced relationship was expected to be imposed upon companies in the near future (five years) was measured on a five point scale (with five indicating that an enhanced relationship was highly expected). The respondents were questioned to consider this obligation in an international context. The perception of the Netherlands as a tax haven has been EU-centered. The tax directors were therefore asked to consider the Dutch taxes in comparison to those in the other EU member states. Scale number 'one' indicated low tax avoidance and 'five' that the Netherlands was considered as a tax haven. In addition, a control variable was put into the sample to exclude the possible impact of other factors on the hypotheses. As larger companies have a larger impact on their environment, they are exposed to more pressure to practice CSR. This possible impact had to be excluded. This is why we introduced a control variable for the number of employees in a company. The number of employees was measured by a logarithm of the actual amount of staff members.

The following method of analysis is used in this paper. The relations among the first three independent variables and the dependent variable (conform the hypothesizes formulated above) were tested by linear regression using SPSS. Therefore will test the formulas below (where Y represents the willingness to participate in an enhanced relationship):

$$Y1 = \alpha + \beta(Business\ environment) + \beta(number\ of\ employees)$$

$$Y2 = \alpha + \beta(short\ term) + \beta(number\ of\ employees)$$

$$Y3 = \alpha + \beta(tax\ haven) + \beta(number\ of\ employees)$$

RESULTS

The descriptive statistics (table 1) are not indicative of an exceptional sample. The willingness to engage in an enhanced relationship (4.100 out of 5) is high in the sample. Moreover, an enhanced relationship is considered to be positive for the business environment (2.421 out of 3). However, the expectation of an enhanced relationship obligation in the near future and the perception of the Netherlands as a tax haven yielded neither positive nor negative scores (3.000 and 2.500 out of 5 respectively). The number of employees in our sample can be considered as high (9.548 after using a logarithm) compared to other research, for example Gallo & Christensen (2011), with an average of 2.28. As our sample included the largest Dutch multinationals, this was, however, to be expected.

Table 1: Descriptive Statistics for the Dependent and Independent Variables

	Mean	*Min*	*Max*	*Std. Dev.*
Dependent variable Willingness	4.100	3	5	0.788
Business environment	2.421	1	3	0.838
Short term	3.000	1	4	1.076
Tax haven	2.500	1	4	0.889
Number of employees	9.548	5.74	12.47	1.661

This table shows descriptive statistics. The first column shows the sample mean. The second and third column show respectively the lowest and highest number in the sample. The fourth column shows the standard deviation from the sample.

The Pearson correlation (table 2) shows only one notable outcome. Tax directors who believe that an enhanced relationship is positive for the business environment also expect this measure to become obligatory in the near future. This finding is significant at the 1% level and has a coefficient of 0.712 indicating that these variables are much related. So, based on this finding it can logically be assumed that if one of these variables would (or not) be related to the willingness to participate in an enhanced relationship, the other would also (or neither). No other correlations were found in the sample.

Hypothesis 1: suggested a relation between the perceived (positive) effect on the business environment and the willingness to participate in an enhanced relationship. The regression results (table 3) present a significant relation on the 1% level (coefficient of 0.729). Based on the sample the perceived effect on the business environment is a major incentive for companies to participate in an enhanced relationship which is also indicated by the high R-squared. With a result of 0.704 the business environment variable explains for a large part the companies' incentive to participate in an enhanced relationship. Hypothesis 1 is therefore accepted.

Table 2: Pearson Correlation with Independent Variables

Variabel	**Business Environment**	**Short Term**	**Tax Haven**	**Employees**
Business environment	1.000			
Short term	0.712***	1.000		
Tax haven	0.131	0.275	1.000	
Number of employees	0.154	0.047	0.061	1.000

*This table shows Pearson correlation. The first column shows the correlations of the business environment variable with the other independent variables. The second column shows the correlations of the short term variable with the other variables. The third column shows the correlation of the tax haven correlation with the other variables. The fourth column shows the correlation of the employees' factor with the other factors. *** Indicate significance at the 1% level, (two-way).*

Hypothesis 2: suggested a relationship between the obligation to participate in an enhanced relationship in the near future (less than five years) and the willingness to participate in such a relationship. The regression results show a significant relation on the 5% level (coefficient 0.336). Based on the sample, the perception that the enhanced relationship is going to be imposed by law in the near future is an incentive for companies to participate in a relationship. The R-squared indicates that this variable also explains for a large part the companies' incentive to participate in an enhanced relationship. Hypotheses 2 is therefore accepted.

Hypothesis 3: assumed a relationship between the perception of the Netherlands as a tax haven and the willingness to participate in an enhanced relationship. The regression results, however, show no significant relation in this respect. Based on the sample, the perception of the Netherlands as a tax haven appears not to be an incentive for companies to participate in an enhanced relationship. Hypotheses 3 is therefore rejected.

Table 3: Enhanced Relationship Willingness Regression Results

	(1)	**(2)**	**(3)**	**(4)**	**(5)**
Constant	2.813	1.395	1.483	2.260	0.701
	(1.039)	(0.645)	(0.833)	(1.109)	(0.556)
Number of	0.135 *	0.093 *	0.120 *	0.127	0.106 *
employees	(0.107)	(0.063)	(0.079)	(0.106)	(0.051)
Business	--	0.729 ***	--	--	0.435 ***
environment **(H1)**		(0.128)			(0.146)
Short term **(H2)**	--	--	0.336 **	--	0.293 **
			(0.117)		(0.115)
Tax haven **(H3)**	--	--	--	0.252	0.152
				(0.197)	(0.096)
R-squared	0.081	0.704	0.530	0.161	0.837
Adjusted R-squared	0.030	0.667	0.474	0.063	0.791
F-value	1.580	18.997 ***	9.569 ***	1.635	18.029 ***

*This table shows regression results. The first column shows the regression results for the control variable number of employees. The second column shows regression results for the business environment independent variable. The third column shows regression results for the short term independent variable. The fourth column shows regression results for the tax haven independent variable. The fifth column shows the regression results for all the variables together. The dependent variable in every regression is enhanced relationship willingness. ***, **, * Coefficient is statistical significant at respectively 1%, 5%, and 10% level.*

DISCUSSION

The aim of this paper is to extend our limited knowledge about enhanced relationships. Specifically, the focus in this paper is on the identification of incentives for companies for enhanced relationship participation. The first part of this paper discussed the existing guidelines for implementing a TCF. In this context, both international and Dutch recommendations for an enhanced relationship were mentioned. It was argued that in implementing a TCF the Dutch guidelines could be replaced by those of other countries without any difficulty. In this respect, an important contribution to the literature has been made by providing an overview of relevant literature which can be universally used. The guidelines mentioned in this overview form the basis for implementing a TCF on a worldwide level.

The second part of this paper presented the analysis of a survey held among 20 tax directors of Dutch multinationals quoted on the largest Dutch stock exchanges. Based on the limited relevant scientific literature available and commons sense we proposed three hypotheses which are tested. The data from the survey with tax directors were used to test the hypotheses. We identified two important incentives which influence the willingness of companies to participate in an enhanced relationship: 1) a (perceived) positive impact on the business environment and 2) the conception that the enhanced relationship measure is going to be imposed in the near future (less than five years). The sample showed that 1) was the most important independent variable for enhanced relationship participation in our sample and considering the high statistical values observed 1) is of great importance for companies to participate in an enhanced relationship in general. These findings are very important for both tax authorities and scholars.

Our results provide the tax authorities with fundaments for a tax policy which stimulates large multinationals to participate in the enhanced relationship approach. We also know, however, that future regulations should focus more on the benefits for the companies in this context. We therefore first recommend a financial incentive for companies, for example, lower compliance costs. This is in accordance with Simone et al. (2013) which concluded that companies strive to minimize the sum of expected taxes and tax-compliance costs. Second, we suggest that a reputation incentive is put in place, for example, by obliging the state's disclosure of the TCF in the annual report. Also for scholars our findings are important: rather than using a purely theoretical approach to the question why an enhanced relationship is or is not a success, our empirical study has shed some light on the actual perceptions/motivations of the businesses in the practical field as regards the perceived relationship policy. In addition, we identified no relation between the willingness to participate in an enhanced relationship and the perception of The Netherlands as a tax haven. This might implicate that companies consider more tax transparency not necessary. Further research could focus on the relation between tax transparency and an enhanced relationship.

Besides, this paper has some limitations, which may give rise to further scientific research. First, as our study was restricted to the Dutch framework, further investigation could address other countries or map out the differences among their national guidelines to further develop an international TCF. Second, this study only focused on a limited amount of incentives influencing the willingness of companies to participate in an enhanced relationship. Follow up research may concentrate on additional incentives. Furthermore, future studies may start from a different context, for example smaller organizations or organizations in different countries. These investigations may produce different outcomes. Third, the sample in this paper was small (2o), which means that one or more items could have had a relatively large impact on the outcome of the study, thereby undermining its generalization. Further research could be focused on overcoming this limitation.

CONCLUDING COMMENTS

This study presented relevant guidelines for implementing a TCF with an emphasis on the Netherlands. In addition, a practical approach was used to identify companies' main incentives to participate in an enhanced relationship. We conducted a survey among the tax directors of large companies quoted on the Dutch stock exchange. Via linear regression we analyzed the data gathered during this investigation. Two of our hypotheses were confirmed: "The perception that an enhanced relationship creates a better business environment is positively related to an organization's willingness to participate in such a relationship" and

"The expectation of the introduction on an international level of an enhanced relationship policy in the near future (five years) is positively related to the willingness of businesses to participate in such a relationship". The third hypothesis was rejected: "The perception of the Netherlands as a tax haven is positively related to the willingness of businesses to participate in an enhanced relationship". In conclusion, we identified two important incentives for companies to participate in an enhanced relationship: the perception that an enhanced relationship has a positive effect on the business environment and the expectation that an enhanced relationship policy will be introduced in the near future.

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