

Large Traders' Customs Units

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Abstract

Revenue collection, a core function of many customs administrations, has recently come under strain owing to the global financial crisis. The World Customs Organization (WCO) Revenue Package initiative, launched in 2009, seeks *inter alia* to promote the exchange of experience and best practices with tax administrations in order to improve the capacity of Customs to collect revenue. This paper describes the experiences and insights of tax administrations in their implementation of Large Taxpayers Units (LTU) and discusses the creation and development of Large Traders' Customs Units (LTCU).

Introduction

The collection of revenue (that is, customs duties, VAT, and other taxes on traded goods) represents a core function of most customs administrations. This function has been negatively affected by the global financial crisis which introduced a sudden and unexpected volatility in trade, resulting in most administrations experiencing a severe reduction in revenue collections. This decline in revenue and the new global economic conditions pose challenges for administrations on how to analyse such trends and effectively perform their core role.

With this in mind, the World Customs Organization (WCO) launched the Revenue Package initiative in 2009 in response to a request by its Members (WCO 2009). This initiative encourages Members to fully and effectively utilise existing WCO tools and instruments related to revenue matters. The WCO Revenue Package also seeks to promote an exchange of experience and best practices with tax administrations in order to enhance customs' capacity to collect revenue.

This paper discusses and recommends the creation and development of Large Traders' Customs Units (LTCU). The proposal considers the successful experience of tax administrations in implementing Large Taxpayers Units (LTU).

This paper highlights the importance of LTCU to customs and revenue collection in terms of revenue risk mitigation. In particular, it focuses on the benefits of creating such units, particularly in relation to concentrations of trade. It also encourages customs administrations to use these units as a means of implementing pilot projects aimed at improving the speed of pre-clearance procedures and the effectiveness of post-clearance audits.

Economic theory: the 'Pareto principle'

The Pareto principle is an economic concept which is used in different fields of research. The principle states that, for many events, roughly 80 per cent of the effects come from 20 per cent of the causes.

Pareto Principle/Postulate

(Business theory) The concept that, when a large number of individuals or organizations contribute

to a result, the major part of the result comes from the minority of the contributors. The Pareto Postulate is that 20% of your effort or clients will generate 80% of your results or business. This is commonly referred to as the 80/20 rule. An actual percentage can be calculated by ranking customers or contributors by volume or any other factor (Hinkelman 2005).

The principle was named after Italian economist Vilfredo Pareto, who observed in 1906 that 80 per cent of the land in Italy was owned by 20 per cent of the population. He developed the principle by observing that 20 per cent of the pea pods in his garden contained 80 per cent of the peas.¹

Over the years the Pareto Principle or 80/20 rule has manifested itself in various ways, including (a) 80 per cent of the results are achieved by 20 per cent of the group; (b) 20 per cent of your effort will generate 80 per cent of your results; and (c) in any process, few elements (20 per cent) are vital and many elements (80 per cent) are trivial;

The Pareto principle is largely used in quality control, finance, biology and other fields of research. It focuses on the unequal distribution and imbalance in relationships. There are different degrees of imbalance (high, significant, moderate, and low) and the Pareto Principle provides a basis for the development of new strategies.

Large Taxpayers' Units

The introduction of Large Taxpayers Units (LTUs) by tax administrations is a well-established practice which is based on the premise that a few large taxpayers account for the majority of an economy's revenue collection (Pareto principle). Tax administrations recognise that large taxpayers are different from other groups of taxpayers, requiring specially designed tax and compliance programs. As such LTUs provide large taxpayers with a single point of contact with the tax administration, and enable the administration to tailor their compliance programs to meet the specific circumstances of the taxpayers' commercial activities.

Several international organisations recommend the practice of establishing LTUs. In particular, the Centre for Tax Policy and Administration (CTPA) at the Organisation for Economic Co-operation and Development (OECD) has published a guide on LTUs. The Centre highlights common compliance issues associated with large taxpayers and identifies practices, innovative programs and initiatives employed by tax administrations to meet these challenges. Among the key findings listed in the guide are:

- Criteria to identify large businesses vary from country to country and include turnover, assets, tax paid, specific industry and other special factors (for example, international transactions).
- The characteristics of large taxpayers are generally very similar in all participating countries. According to the guide they have a complex structure with multiple operating entities engaged in international business and account for a large share of tax revenue.
- All tax administrations structure the compliance operations of their LTUs along industry lines which, for some, reflect the main sectors of their economy. In addition, some tax administrations have special units to perform risk analysis and intelligence-gathering, provide technical advice, and to monitor and evaluate performance.
- Tax administrations use risk management extensively to manage and prioritise their tasks. Although there are some general similarities in the approach adopted, the levels of risk analysis and response vary from one country to another in reflection of their experience with compliance issues and the degree of non-compliance by large taxpayers.
- Compliance issues may vary from one country to another. However, all participating countries cite tax compliance as a major area of activity and concern in relation to international transactions and business structures.

- All countries are focused on nurturing a better relationship between the tax administration and large taxpayers and this approach is contributing to greater co-operation and openness.
- There is an increase in compliance activities using non-traditional approaches. Trends suggest a shift from the post-filing of tax return examinations towards a 'real-time' evaluation of risk and resolution of compliance issues. A number of countries have commenced various programs to provide certainty to large taxpayers as well as to identify and resolve compliance issues at an early stage.
- Certain tax administrations are devoting greater attention to corporate governance principles and practices. Considering the importance of tax as a financial asset, a number of them believe that the responsibility of a company's tax policy should be vested in the management. Corporate governance principles in some countries are influencing large taxpayers' behaviour and there are indications that tax administrations are using these principles to improve tax compliance.
- In order to enhance enforcement and customer service, all participating countries have programs in place to develop, train and maintain a highly qualified workforce. All countries recognise that the complexity of tax law, business structures and transactions in the large business segment have created a need for specialised knowledge and expertise in certain areas.
- Most participating countries have made it clear that tax policy is the responsibility of the Ministry of Finance but they also recommend that the tax administration should play an active role in providing input and feedback on tax policy to ensure that the tax administration's needs are taken into account.
- Technology should be utilised to manage compliance and improve the quality of service to large taxpayers. This includes the ability to identify risk early and the increased operational efficiency of large business units. A number of countries have developed programs and systems to collect additional data in a timely fashion thereby enhancing compliance risk assessment, facilitating resource decisions and ensuring the consistent treatment of large taxpayers in certain business segments (OECD 2009).

The Fiscal Reform and Economic Governance Project (2010) regards the creation of LTUs as a tax administration structural indicator. Those tax administrations that have set up a unit devoted solely to the largest taxpayers tend to receive a better evaluation than those that have not.

Large Taxpayers Unit (LTU)

This is a tax administration structural indicator. Tax administrations that have a unit devoted solely to tending to the largest taxpayers are indicated with a '1' whereas those tax administrations that do not have such a unit are indicated with a '0'. It is received [*sic*] wisdom that tax administrations should establish large taxpayers units. In some countries, segmentation of taxpayers may go much further. Indeed, some countries establish special units for medium and small taxpayers, as well (Fiscal Reform & Economic Governance 2010).

The International Monetary Fund (IMF) is another international organisation that emphasises the importance of establishing LTUs in order to improve the effectiveness of tax administrations.

Beginning in the 1980s, the IMF has recommended that member countries facing revenue crises establish an LTU as a means to strengthen tax administration. In addition, establishment of an LTU has allowed many countries with scarce resources to begin implementing reform measures for immediate and visible results (Baer, Benon & Toro 2002, p. 36).

Hemming, Cheasty and Lahiri (1995) writing about ways to mitigate the revenue decline in the Baltic countries, Russia, and other countries of the former Soviet Union underline the need to create an LTU:

A large-taxpayers unit should be created. It would monitor collection of taxes from important taxpayers who, although not numerous, account for the major part of tax revenue. In energy-exporting economies, a few large taxpayers can account for 90 per cent of total revenue. In some countries, large taxpayers engaged in cash cropping and processing account for a substantial part of revenues. A large-taxpayers unit properly focuses initial efforts of tax administration reform on the adoption

of more efficient procedures for the more important taxpayers, rather than on the increasing number of small taxpayers whose revenue contribution is not substantial (Hemming, Cheasty & Lahiri 1995, p. 91).

In summary, a significant number of tax administrations has established, with positive results, the special treatment of different taxpayers or taxpayer segments. A few examples are Australia, Bangladesh, Brazil, India, the Netherlands, New Zealand, Pakistan, Sri Lanka, the United Kingdom and the United States of America.

The concentration of international trade

In several economies a relatively small number of traders and a few significant import/export products account for a large share of international trade. The degrees of trade concentration depend on factors such as geography, internal market size, industrialisation, national income, and dependence of exported/imported commodities.

Concentration of traders

The globalisation of business together with firms' increasing ownership of different stages of the production process have contributed to the growth in intra-firm trade over the last decade. Nowadays, it is common to find trade between multinationals and their majority-owned foreign affiliates.

It is important to note that the size of a large trader will vary from country to country although some major characteristics remain the same:

- Revenue concentration: a few traders account for a disproportionately large amount of trade and revenue
- Business complexity: large traders conduct complex business operations
- Professional advisers: large traders have professional advisers for customs procedures and taxes
- Multinational companies: large traders are generally related to multinational companies.

When dealing with large traders, customs administrations are faced with a range of compliance management issues such as multiple units of operation; high volume of imports/exports; complex international sales contracts (royalties, engineering projects, financial terms); cross-border transactions with related parties; complex fiscal issues relating to tax law and accounting principles; policies and strategies to minimise tax liabilities as well as complex financing and business structures.

Concentration of products

The International Trade Statistics Report 2009, issued by the World Trade Organization describes merchandise trade by product. This approach highlights the importance of trade in agriculture, fuels and mining products, manufactured goods, office and telecom equipment, automotive products, clothing, cut flowers as well as the importance of Export Processing Zones (EPZs).

According to the report, several countries spend a significant part of their foreign exchange earnings on importing fuels and mining products. In some cases this share exceeds 75 per cent. Large emerging economies rely heavily on the import of ores and other minerals.

Iron and steel are the primary exports of manufactured goods followed by chemicals and transport equipment. Office and telecommunications products (for example, mobile phones and computer components) are designated high-risk products due to the fact that they are high-value and low-volume goods.

China is the leading exporter of clothing products. The competition in this export sector is fierce and involves countries from Asia (such as India and Bangladesh), and the Americas (such as Mexico, Brazil and the Dominican Republic).

The report is an important source of information concerning the concentration of regional and national products in imports and exports. Customs administrations should make full use of such statistical reports and tools in order to understand the conditions of international trade which are constantly fluctuating. It is necessary to identify high-risk products such as office and telecommunications equipment, automotive and pharmaceuticals products as well as clothing and machinery, and to monitor them closely.

LTCU and Authorised Economic Operators

The WCO's SAFE Framework of Standards is an international instrument designed to provide a safer world trading regime and new working methods for customs administrations. The Authorised Economic Operator (AEO) concept is one of SAFE's core elements of promoting partnerships between customs and business. An AEO is defined as:

[A]... party involved in the international movement of goods in whatever function that has been approved by or on behalf of a national Customs administration as complying with WCO or equivalent supply chain security standards. Authorized Economic Operators include inter alia manufacturers, importers, exporters, brokers, carriers, consolidators, intermediaries, ports, airports, terminal operators, integrated operators, warehouses, distributors (WCO 2007).

Several customs administrations have developed AEO programs under different names and which reflect different approaches: the United States (C-TPAT – Customs-Trade Partnership against Terrorism), United Kingdom, Sweden, the Netherlands, New Zealand (SES – Secure Export Scheme), Singapore (STP – Secure Trade Partnership), Brazil (Express Customs System – Blue Line), Canada (PIP – Partners in Protection) and several others.

Some AEOs programs are open to all operators in the supply chain while others are restricted to importers/exporters. The ultimate goal of such programs is mutual recognition. This refers to the recognition of accredited AEOs in different countries thereby contributing to the establishment of secure supply chains. Some countries have already accredited operators on the basis of Mutual Recognition Agreements (MRA).

At present, countries have the challenge of implementing AEO programs and signing an MRA without having a specific structural unit to perform the task. Depending on the structure of the customs administration, the existing clearance and/or audit units will be the ones in charge. However, they are preoccupied with other problems and have few resources to develop new initiatives.

The innovative concept of the AEO and its apparent complexity makes it perfectly suited to the LTCU. As a matter of fact, most accredited AEOs also happen to be large traders/taxpayers. Therefore, the LTCU would fill the gap as the ideal unit to develop, implement and host the program. Technical assistance and capacity building on best practices for LTCU could be provided by international organisations.

This proposal is plausible since the conditions and requirements for AEOs already suggest that an AEO will probably be a large trader/taxpayer (WCO 2007, pp. 37-48):

- A. Demonstrated compliance with customs requirements:** Customs shall take into account the demonstrated compliance history of a prospective AEO when considering the request for AEO status.
- B. Satisfactory system for management of commercial records:** The AEO shall maintain timely, accurate, complete and verifiable records relating to import and export. Maintenance of verifiable commercial records is an essential element in the security of the international trade supply chain.

- C. Financial viability:** Financial viability of the AEO is an important indicator of an ability to maintain and improve upon measures to secure the supply chain.
- D. Consultation, co-operation and communication:** Customs, other competent authorities and the AEO, at all levels, international, national and local, should consult regularly on matters of mutual interest, including supply chain security and facilitation measures, in a manner which will not jeopardize enforcement activities. The results of this consultation should contribute to Customs development and the maintenance of its risk management strategy.
- E. Education, training and awareness:** Customs and AEOs shall develop mechanisms for the education and training of personnel regarding security policies, recognition of deviations from those policies and understanding what actions to be taken in response to security lapses.
- F. Information exchange, access and confidentiality:** Customs and AEOs, as part of an overall comprehensive strategy to secure sensitive information, shall develop or enhance the means by which entrusted information is protected against misuse and unauthorized alteration.
- G. Cargo security:** Customs and AEOs shall establish and/or bolster measures to ensure that the integrity of cargo is maintained and that access controls are at the highest appropriate level, as well as establishing routine procedures that contribute to the security of cargo.
- H. Conveyance security:** Customs and AEOs shall jointly work toward the establishment of effective control regimes, where not already provided for by other national or international regulatory mandate, to ensure that transport conveyances are capable of being effectively secured and maintained.
- I. Premises security:** Customs, after taking into account the views of AEOs and their necessary compliance with mandatory international standards, shall establish the requirements for the implementation of meaningful Customs-specific security enhancement protocols that secure buildings, as well as ensure the monitoring and controlling of exterior and interior perimeters.
- J. Personnel security:** Customs and AEOs shall, based on their authorities and competencies, screen the background of prospective employees to the extent legally possible. In addition, they shall prohibit unauthorized access to facilities, transport conveyances, loading docks and cargo areas that may reasonably affect the security of those areas in the supply chain under their responsibility.
- K. Trading partner security:** Customs shall establish AEO requirements and mechanisms whereby the security of the global supply chain can be bolstered through the commitment of trading partners to voluntarily increase their security measures.
- L. Crisis management and incident recovery:** In order to minimize the impact of a disaster or terrorist incident, crisis management and recovery procedures should include advance planning and establishment of processes to operate in such extraordinary circumstances.
- M. Measurement, analyses and improvement:** The AEO and Customs should plan and implement monitoring, measurement, analysis and improvement processes in order to:
 - assess consistency with these guidelines;
 - ensure integrity and adequacy of the security management system;
 - identify potential areas for improving the security management system in order to enhance supply chain security.

It is likely that large traders/taxpayers will be able to comply with the WCO conditions and requirements.

In summary, the concept of an LTCU is directly related to the AEO concept and should be seen as a complementary strategy to achieve positive results in relation to Customs' priority mission (that is, providing a safer system of world trade and developing modern working methods).

Brief guidance on LTCUs

Some of the key components in the establishment of an LTCU include the mission, human resources, risk management, audits and enforcement. The following briefly outlines some of these components.

LTCU mission

The mission of an LTCU should be to recognise the different characteristics and behaviours of large traders in order to obtain the most favourable balance between compliance and facilitation programs. This will ensure more effective risk management and higher levels of compliance.

Human resources

Human resources is a key element of a successful LTCU program. The complex business activities of a large trader demand that human resources assigned to the LTCU should be well versed in information technology (IT) and audit skills. Training courses should also ensure that participants understand the economic conditions governing trade at national and international levels. Thereby, Customs will focus controls on the most important sources of trade in order to optimise their use of restricted human resources.

Risk management

Risk management should be extensively used to manage and prioritise customs tasks. A focus on establishing Customs-Business partnerships is of fundamental importance in improving risk management.

IT also plays an extremely important role in the creation of a successful risk management and LTCU program. For example, there should be an effective registration process for assigning a unique taxpayer identification number (TIN) to each existing taxpayer. Normally, tax administrations already have a unique TIN and so Customs should arrange to use this system and make adjustments or improvements where necessary.

Since taxpayers are not necessarily traders, Customs can impose special controls on those taxpayers who are also large traders. This would serve to expand the base of legitimate large traders and to help stamp out fraudulent importers.

IT could also be harnessed by LTCUs to introduce self-assessment principles for filing, payment and simplified collection procedures.

Audits and enforcement

Audit selection by LTCUs tends to produce better results in terms of enforcement and tax collection. The creation of such units will serve to shift responsibility for audit selection from local units to customs headquarters or important regional units.

The experience of LTCUs in Bosnia and Herzegovina illustrates this recommendation:

Tax enforcement intensified with the new Tax Administration Law. Several divisions that were established in the months preceding enactment of the Law—including units for Enforced Collections, Investigation and Intelligence, and a Large Traders' Customs Unit (LTCU)—were carried over under the new organizational structure to perform a variety of enforcement-related functions. ... Audit selection was shifted from the cantonal offices, which were rumored to be susceptible to local influence, to the Tax Administration headquarters in Sarajevo. With the establishment of the Investigation and Intelligence Unit, and with the cantonal offices reporting directly to the central office, audits and investigations began to be conducted on a more consistent basis (Rozner, Šahinagić & Marjanović 2005, p. 33).

In some cases, this type of audit will necessitate a Mutual Assistance Agreement (MAA) to be concluded between different national customs administrations.

An LTCU's enforcement plan should be directed towards fraudulent importers who account for large revenue and economic losses. One example is Missing Trader Intra-Community (MTIC) fraud which is divided into two main types: acquisition and carousel fraud. Using the UK as an example:

Acquisition fraud is where the goods are imported from the EU into the UK by a trader who then goes missing without completing a VAT return or Intrastat declaration. The 'missing trader' therefore has a VAT free supply of goods, as they make no payment of the VAT monies due on the goods. He sells the goods to a buyer in the UK and the goods are available on the home market for consumption.

Carousel fraud is similar to acquisition fraud in the early stages, but the goods are not sold for consumption on the home market. Rather, they are sold through a series of companies in the UK and then re-exported to another Member State, hence the goods moving in a circular pattern or 'carousel' (Ruffles et al. 2003, p. 59).

This type of fraud is also found in other countries with VAT or internal taxation controlled by different states.

Conclusions

This paper has argued that Customs should learn from the tax administrations' successful experience with LTUs and create LTCUs where they are needed. This proposal is supported by economic theory and the concentration of international trade which suggest that a few traders and products are responsible for a large share of total customs revenue.

The advantages of establishing LTCUs in the customs environment should be similar to those reported by tax administrations when establishing LTUs: (1) improved identification and knowledge of large taxpayers and their operations; (2) more timely and accurate return filing and payment by large taxpayers; (3) earlier detection of taxpayers' failure to comply with filing and payment obligations; (4) more effective audits targeted by economic sector and performed by better-trained auditors; (5) a reduced stock of arrears, and therefore more targeted efforts by collection enforcement officers; and (6) better-trained staff able to deal with more complex tax issues, provide quality services to taxpayers as well as to detect irregularities and corrupt practices (Baer, Benon & Toro 2002, p. 16).

To maximise their utility, LTCUs should be staffed by motivated officers who would monitor and analyse commercial trends as well as the compliance behavior of relevant traders and other stakeholders. This approach will also provide an important avenue for enhancing customs expertise in the area of compliance management.

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Endnotes

- 1 The Pareto Principle is also referred to as 'Pareto's Law', the '80/20 Rule', the '80:20 Rule', and the '80 20 Rule'.

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