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Tax Dispute Resolution and Taxpayer
Screening

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Abstract

The purpose of this paper is to examine the characteristics of the National Tax Tribunal, and the functions possessed by dispute resolutions coming from this tribunal according to a law and economics perspective. As for the results, we clarify that by using the tax office can use the National Tax Tribunal to offer an income tax that minimizes taxpayer expected costs, and thus can screen taxpayers according to type.

Keywords: Income tax, Tax disputes, Alternative Disputes Resolution, National Tax Tribunal, Screening

JEL Classification: K34, K41

1. Introduction

This paper conducts a theoretical examination, from legal and economic perspectives, of the characteristics of the Japanese National Tax Tribunal, and the functions of dispute resolutions coming from this tribunal.

The typical assumption in the economic literature is that taxpayers have a good understanding of their own incomes when filing their income tax returns. (For examples, see Cowell (1987, 1990), Mookherjee (1997), and Andreoni et al. (1988).) However, in reality there are times when the legal interpretation of income differs between the taxpayer and the tax office.

For example, a professor (the taxpayer in this case) in Japan interpreted income from a university other than that where he was employed full-time as miscellaneous income. However, the tax office interpreted this income as employment income, and imposed additional tax on the taxpayer in this case. The professor filed an objection against the tax office's decision and fought the matter in court, ultimately losing the case. The National Tax Tribunal in Japan offers out-of-court arbitration of disputes like this, which concern national tax matters (i.e. alternative dispute resolution, or ADR).

Kamphorst and van Velthoven (2009) conducted ground-breaking research on tax disputes in the Netherlands, but no subsequent literature has examined the

legal and economic aspects of out-of-court dispute resolution in relation to national taxes. Particularly, theoretical economics research regarding out-of-court dispute resolutions for Japanese national taxes is rare, though there are valuable exceptions like Ramseyer and Rasmusen (1999).

The model in this paper focuses attention on the following characteristic of the National Tax Tribunal (The characteristics of the tribunal are stipulated in articles 75, 78, and 115 of the General Act of National Taxes.): In the event that the tax office makes a decision regarding the taxpayer, the taxpayer can file an objection to the tax office or apply to the National Tax Tribunal for a review before disputing the matter in court.

This characteristic shows that the National Tax Tribunal is a vehicle for ADR. Besides the National Tax Tribunal, in Japan there are other governmental ADRs, including: the Radio Regulatory Council, Environmental Disputes Coordination Commission, Japan Patent Office, Japan Marine Accident Inquiry Agency, Labor Relations Commission, and Fair Trade Commission. However, according to documents published by the Cabinet Office, 72.5% of the 3,382 disputes resolved by these organizations in 2004 were resolved by the National Tax Tribunal.

The aim of the results demonstrated in this paper is as follows: By using procedures at the National Tax Tribunal, an arbitral institution, to resolve disputes between taxpayers and tax offices to sort a large general population of taxpayers

into those more and less likely to dispute a matter, it becomes possible to minimize the cost of the burden assumed by all taxpayers.

The organization of this paper is as follows: The next section investigates the value of filing disputes with the National Tax Tribunal as an efficient means of screening a heterogeneous group of taxpayers. The third and final section offers interpretation of the results obtained from this paper.

2. The Model

A large number of taxpayers exist, out of which a taxpayer i calculates his own income, where his income tax is represented as t_i . The tax office j evaluates the taxpayer's income and computes his income tax, represented as t_j . Even if the taxpayer and tax office are examining the same information, their interpretations of what constitutes income differ, so $t_i \neq t_j$.

This paper ignores cases where the tax office issues refunds to focus instead on cases where the taxpayer can profit from filing a claim against the tax office for incorrect interpretation of income, so the following is assumed: $0 < t_i < t_j$.

The scenario is as follows: The tax office j informs taxpayer i that they need to pay income tax t_j . According to the principle of the continuance of execution (article 105 of the General Act on National Taxes), the taxpayer

chooses whether to dispute the issue via the National Tax Tribunal after paying an amount $t = t_j - t_i$.

Every taxpayer is heterogenous in the following way: Their subjective value v of taking a dispute to the National Tax Tribunal is different. This value is continuously distributed on the closed interval $[\underline{v}, \bar{v}]$. However, the right of every taxpayer to take a dispute to the National Tax Tribunal is not considered undesirable, so the value \underline{v} is assumed to be non-negative.

Several factors could bring differences in v , and lead to heterogeneity among the taxpayer base. These factors include underlying ideologies that lead people to assert their rights, levels of evidence sufficient to support a National Tax Tribunal dispute, and asset levels sufficient to let people pursue frivolous disputes. However, these specific factors will not be investigated in this paper.

When the tax office offers a taxpayer a payment of t , if $v \leq t$ then the taxpayer will pay t without any further dispute. On the other hand, taxpayers with $v > t$ will pay t and subsequently take the dispute to the National Tax Tribunal.

The probability distribution and probability density of v , which are defined in the interval $[\underline{v}, \bar{v}]$, are each respectively represented as the continuous functions $F(v)$ and $f(v)$, and are assumed to be common knowledge.

In this case, given $t \in [\underline{v}, \bar{v}]$, the taxpayer will not initiate a dispute with probability $\int_{\underline{v}}^t f(v)dv$ and will initiate a dispute with probability $\int_t^{\bar{v}} f(v)dv$.

When the taxpayer's expected cost is C^e , this cost can be expressed as the following equation:

$$C^e = t \int_{\underline{v}}^t f(v)dv + c_i \int_t^{\bar{v}} f(v)dv \quad (1)$$

Equation (1) can also be further rewritten as follows:

$$\begin{aligned} C^e &= tF(t) + c_i \int_t^{\bar{v}} f(v)dv \\ &= tF(t) - c_i \int_{\bar{v}}^t f(v)dv \\ &= tF(t) - c_i [F(v)]_{\bar{v}}^t \\ &= tF(t) - c_i (F(t) - F(\bar{v})) \end{aligned} \quad (2)$$

Taking the differential of equation (2) provides the following:

$$dC^e / dt = F(t) + (t - c_i) f(t)$$

Denoting the value of t that minimizes C^e as t^* gives the first-order condition that minimizes the expected cost:

$$F(t^*) + (t^* - c_i)f(t^*) = 0 \quad (3)$$

When c_i is sufficiently small, the second-order condition that minimizes the expected cost is met:

$$(1 - c_i)f(t^*) + (t - c_i)f'(t^*) > 0 \quad (4)$$

The results of the preceding analysis are summarized as follows:

Proposition 1: There exists an offer that minimizes the expected costs of a taxpayer who initiates a dispute through the National Tax Tribunal if the cost associated with such a dispute is sufficiently small.

Assuming that the probability distribution function of equation (3) is uniform, it becomes $F(t^*) = (t^* - \underline{\nu})/(\bar{\nu} - \underline{\nu})$, and the probability density function becomes the constant value function $f(t^*) = 1/(\bar{\nu} - \underline{\nu})$. In this case, $t^* = (\underline{\nu} + c_i)/2$. If the tax office offers a taxpayer income tax corresponding to t^* , as long as $c_i < 1$, it is possible to minimize the taxpayer's expected cost.

When this happens, the taxpayer with $\nu < (\underline{\nu} + c_i)/2$ will not initiate a dispute, but the taxpayer with $\nu \geq (\underline{\nu} + c_i)/2$ will bring a dispute to the National Tax

Tribunal. This means that the tax office screens heterogenous taxpayers through the offers that it gives them. Consequently, by attributing a specific probability distribution function, the following result can also be obtained.

Proposition 2: If the tax office offers an income tax that minimizes the taxpayer's expected cost, then provided the burden of this cost incurred by the dispute brought by the taxpayer to the National Tax Tribunal is sufficiently small, it is possible to screen types of taxpayers.

It is important to note that the assumption in both cases is that c_i is sufficiently small. If c_i is excessively large, no taxpayers will bring a dispute, so manipulating c_i to be sufficiently small not only helps reduce the taxpayer burden but also affects policy implications such as screening practices.

Applying the implicit function theorem to equation (3) makes it possible to attain the following result:

$$dt^* / dc_i = f(t^*) / (2f(t^*) + (t^* - c_i)f'(t^*)) \quad (5)$$

This means that at equilibrium, decreasing c_i increases the number of people using the National Tax Tribunal or increases the possibility that people will use it.

3. Conclusion

This paper has demonstrated that, as long as the National Tax Tribunal procedures are available at low cost to the taxpayer, the tax office can minimize the expected costs of all taxpayers, while simultaneously providing screening for general taxpayers by sorting them into those who will bring a dispute to the National Tax Tribunal and those who will not.

From a legal standpoint, a taxpayer can use the National Tax Tribunal procedures to assert his rights, but economically speaking, the act of applying for review reveals taxpayer type.

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