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Master's Thesis of Graduate School of Public  
Administration

A study on major issues of  
Offshore Voluntary Disclosure  
Program in South Korea

– focusing on inducing voluntary tax compliance –

자발적 신고제의 주요 쟁점에 관한 연구  
– 납세순응도의 유도를 중심으로 –

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# Abstract

The Offshore Voluntary Disclosure Program is a new approach to tackling offshore tax evasion that offers taxpayers the opportunity to improve their compliance. This paper analyzes whether the Offshore Voluntary Disclosure Program in Korea can increase tax compliance, and suggests improvements to make this system work more effectively. The author stresses that increasing government spending and the seriousness of offshore tax evasion necessitate the Offshore Voluntary Disclosure Program. The Offshore Voluntary Disclosure Program itself has been examined to have no critical problems, considering other voluntary disclosure programs in foreign countries. The Offshore Voluntary Disclosure Program has an appropriate incentive structure to influence tax compliance positively for all taxpayers including both compliant and non-compliant taxpayers. This paper emphasizes that congruity between the Offshore Voluntary Disclosure Program and relevant institutions is key to the program's success. General enforcement efforts such as tax audits and the Foreign Financial Accounts Reporting should be gradually enforced. In the course of implementing the Offshore Voluntary Disclosure Program, the tax authority needs to reinforce its communication strategy with both targeted taxpayers and compliant taxpayers. Finally the author calls for greater attention to the reform of the tax system in the belief that simplifying the tax system is a fundamental method for discouraging tax evasion.

**Keyword** : tax evasion, international taxation, offshore voluntary disclosure program, tax amnesty, tax compliance

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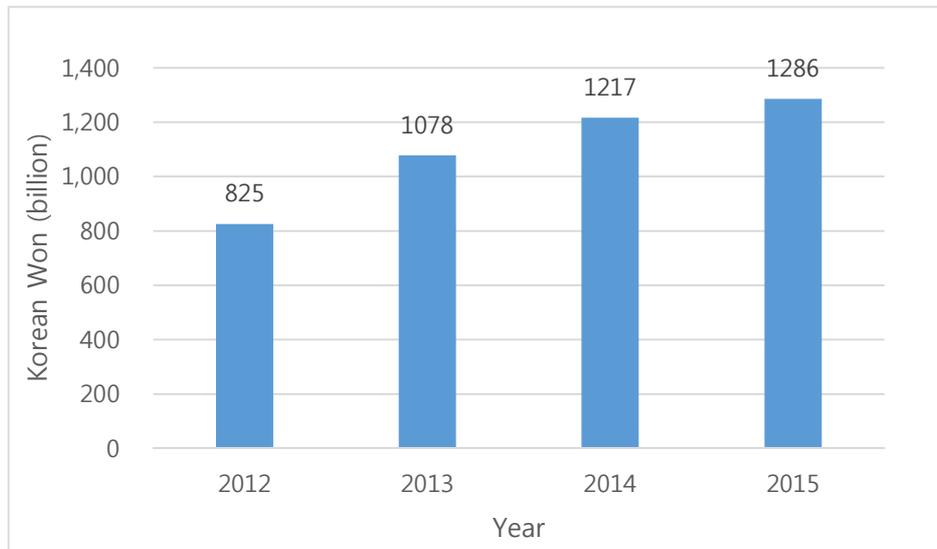
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# 1. Introduction

As capital moves freely across the world and international transactions become complicated, multinational companies and high-earners evade tax burdens by shifting their profits and incomes into so-called tax havens, which are low-tax countries located around the world, especially, in the Caribbean and European. By concealing the ownership of their offshore income and assets, the taxpayers engage in international tax evasion (Lederman, 2012). According to the Tax Justice Network, \$21 to \$32 trillion financial wealth is estimated to be invested tax-free through offshore jurisdictions. If non-financial wealth such as real estate were included, the total of hidden offshore assets would be much more (Tax Justice Network, 2012). Considering the size of offshore income and assets, commensurate losses of tax bases and revenues are enormous. Although there is no reliable estimate of the size of offshore tax evasion in South Korea, the National Tax Service levied 1,286 billion Korean Won through tax audits for 223 offshore tax evasion suspects in 2015. The amount of levied tax is increasing: 825 billion (2012), 1,078 billion (2013), 1,217 billion (2014), and 1,286 billion (2015) (National Tax Service, 2016). Therefore, a significant amount of tax revenue is estimated to be evaded through offshore tax evasion. The resulting loss of tax revenue may cause serious damage to the function of the government.

**Figure 1. Taxes levied through offshore tax evasion audits**



Offshore tax evasion deteriorates efficiency and equity of the tax system. The first problem is efficiency. Efficiency increases when tax base broadens and tax rate lowers. Therefore, raising tax rates to recover revenue losses caused by tax evasion will decrease efficiency. The second problem is vertical equity. The higher-income groups have a more scope for tax evasion than low-income groups whose incomes are usually withheld from their wages. The incomes of the wealthy are more complex and they are able to get advice from experts, such as lawyers and accountants. Especially, in the case of offshore tax evasion, multinational companies may manipulate their international trade. The third problem is horizontal equity. The tax system treats two entities differently that are in similar circumstances. While the one abiding by the tax law is unfavorable, international companies are more favorable than domestic firms (Gruber, 2013). These problems worsen in current circumstances. First, income inequality has risen in most OECD

countries since the 1980s. In 2010, disposable income of the top 10% of earners was around 9.5 times higher than that of bottom 10%; a quarter of a century ago, it was around 7 times higher (Keeley, 2015). In South Korea, top 1% income shares remained low - 6% ~ 8% - throughout the rapid industrialization period, but they began to ascend in the mid-1990s after the economic crisis. 2008 data show that top income shares are around 10% ~ 12% (Kim & Kim, 2015). Second, the government budget deficits are increasing. The budget deficits are expected to continue because the recent economic recession requires the increase of government expenditures and the demand for social welfare spending is increasing.

In this situation, tax authorities worldwide engage in a number of efforts to prevent offshore tax evasion. For example, OECD published an “Action Plan on Base Erosion and Profit Shifting (BEPS)” in July 2013. It addresses the tax challenges caused by the digital economy; the digital economy makes it easier for multinational enterprises to manipulate different tax systems to “artificially reduce taxes or shift profits to low-tax jurisdictions” (OECD, 2015a). Exchange of information is a key element of international cooperation for offshore tax evasion; because, it is hard for a single country to find out hidden assets worldwide. The BEPS project foresees that tax authorities will automatically exchange important tax information of multinational enterprises (such as profits, taxes paid, and assets) with each other. In addition, the Common Reporting Standard (CRS) was developed and approved by the OECD on 15 July 2014 in response to the G20 request. The CRS requires jurisdictions to gain information from

their financial institutions and automatically exchange the information with others annually. In October 2014, 51 countries (including South Korea) signed the Multilateral Competent Authority Agreement (MCAA) which is “a multilateral framework agreement that provides a standardized and efficient mechanism to facilitate the automatic exchange of information.”<sup>1</sup>

In South Korea, the National Tax Service joined JITSIC (Joint International Tax Shelter Information Center) in 2010, whose objective is to “identify and understand abusive tax schemes, to share expertise, best practices, and experience in combating these schemes, to exchange information on abusive tax schemes, promoters, and investors, and to enable participants to better address these schemes without regard to national borders” (National Tax Service, 2009). As of June 2013, South Korea signed income tax conventions with 80 countries and all of conventions have tax information exchange agreements. Moreover, South Korea concluded information exchange agreements with three countries – Cook Islands, Marshall Islands, and Bahamas (Byun, 2013). The government is trying to amend existing tax treaties in order to supplement tax information exchange.

The new approach to tackling offshore tax evasion is to encourage voluntary cooperation from taxpayers. For example, from June 2011, the Foreign Financial Accounts Reporting was implemented. It requires that residents or domestic corporations file information on overseas financial

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<sup>1</sup> OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes, <http://www.oecd.org/tax/transparency>

accounts. In addition, the government implemented the Offshore Voluntary Disclosure Program on 1 September 2015. The program provides taxpayers with a temporary opportunity to correct past offshore tax evasion voluntarily. There are still uncertainties in the achievement of the Offshore Voluntary Disclosure Program. However, the program can facilitate compliance in a timely and cost effective fashion because complicated transactions among many countries make it difficult for a single country to discover offshore tax evasion. In addition, confronted with the government's efforts against offshore tax evasion, tax evaders face fear of being uncovered by tax authorities. Tax evaders see growing incentives for reporting their assets and incomes correctly and coming back to the normal system. In this sense, the need of offshore voluntary disclosure program gets support as a useful tool to bring offshore hidden assets and incomes to the open system by utilizing taxpayers' cooperation.

The government operated the Offshore Voluntary Disclosure Program temporarily from 1 October 2015 to 31 March 2016.<sup>2</sup> The tax compliance would improve cost-effectively if the intended consequences of the Offshore Voluntary Disclosure Program happened. However, the effect of the Offshore Voluntary Disclosure Program is still the question under debate. Thus, researching theoretical and practical issues on the Offshore Voluntary Disclosure Program is necessary for dealing with offshore tax evasion. The traditional approach to tax evasion is that a tax authority

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<sup>2</sup> <http://www.mosf.go.kr/ovdp>

discovers incomes and assets that tax evaders hide. However, this new approach is opposite; the tax authority waits for taxpayers' cooperation. It gives incentives when taxpayers disclose their hidden offshore incomes or assets. The issue is that the government does not have complete knowledge of how taxpayers will react. There are many factors influencing the behavior of taxpayers. Analyzing these factors is essential for implementing this institution successfully.

This paper analyzes the necessity of offshore voluntary disclosure program in the Korean context and how the government should implement the program in order to successfully achieve the increase in voluntary tax compliance. The paper studies experiences from other countries and get lessons from them. The author suggests improvements to make this system work more effectively.

## **2. Impacts of Offshore Voluntary Disclosure Program on Tax Compliance**

### **(1) Characteristics of Offshore Voluntary Disclosure Program**

Offshore voluntary disclosure program has characteristics of tax amnesty. Tax amnesty is a limited-time offer that the government gives to certain groups of taxpayers. The taxpayers pay a defined amount tax, not a

full amount, relating to previous tax periods. In return, they receive forgiveness of a tax liability (including interest and penalties) and freedom from legal prosecution (Baer & LeBorgne, 2008). Under offshore voluntary disclosure program, “eligible taxpayers report their delinquent taxes in exchange for reduced penalties, a reduced likelihood of criminal prosecution upon detection of the tax evasion, or both.” Therefore, offshore voluntary disclosure program is a form of tax amnesty (Lederman, 2012).

There are two types of offshore voluntary disclosure programs. (i) The first one is called “general rules”, which require residents or domestic corporations holding an overseas financial account to file information on the account. For example, there is “Foreign Financial Accounts Reporting” in South Korea and “FBAR: Report of Foreign Bank and Financial Accounts” in the United States. (ii) Another one is called “special programs”, which offer additional incentives, such as reduced penalties and protection from prosecution, and run for some specific period of time. The terms of this program usually involve a limited-time offer by the government to a specified group of taxpayers to settle undisclosed or unpaid tax liabilities for a previous period as an exchange for defined concessions over civil or criminal penalties. These special programs exist in 13 countries in OECD (OECD, 2010). Generally, “Offshore Voluntary Disclosure Program” is considered as “special programs”. In this paper, “Offshore Voluntary Disclosure Program” refers only to “special programs”.

The aims of an offshore voluntary disclosure program are typically (i) to increase tax revenues in a cost effective manner and (ii) to improve tax

compliance. Additionally, the program may aim (iii) to repatriate capital invested abroad. Although the additional revenues in the short run may seem appealing, it is more important to broaden the tax base, improve tax compliance, and increase the long-term revenues. However, the program has risk that it will encourage tax evaders to skim off the benefits of the program but keep non-compliant, and disappoint the majority who already comply, which results in the fall of overall compliance levels. Therefore, to succeed, the program should be designed to encourage non-compliant taxpayers to permanently improve their compliance and retain the support and compliance of the vast majority of taxpayers (OECD, 2010).

## **(2) The concept of tax compliance**

As a public finance topic, tax compliance is related to the notions of equity and efficiency. “If the wealthy can systematically evade a larger share of their taxes than can the poor, then the effective tax system will be less equitable than the legislated one.” Also, given a fixed revenue requirement, any effort at tax evasion causes deadweight loss, which are costs of tax compliance (Andreoni, Erard, & Feinstein, 1998). The concept of tax compliance in the simple form is the degree to which taxpayers comply with the tax law. “Compliance with the tax law typically means: (i) true reporting of the tax base, (ii) correct computation of the liability, (iii) timely filing of the return, and (iv) timely payment of the amounts due” (Franzoni, 1999). In wider and more comprehensive version, however, it

means “the willingness of individuals and other taxable entities to act in accordance within the spirit as well as the letter of tax law and administration without the application of enforcement activity.” Unfortunately, the problem is that there is actually no method to calculate all these aspects. Taking the narrow definition, the degree to which taxpayers abides by the law can be measured by the ‘tax gap’, which represents “the difference between the actual revenue collected and the amount that would be collected if there were 100 percent compliance” (James & Alley, 2002). In other words, it is the difference between the taxes taxpayers actually owe and what they voluntarily report and pay before the due date (Andreoni, Erard, & Feinstein, 1998). According to this narrow definition, the increase of tax revenues can be viewed as the improvement of tax compliance when all other things being equal.

The measurement of tax gap requires systematic methods and a lot of information. A few countries, such as the United States and the United Kingdom, announce their tax gap. According to the Internal Revenue Service (IRS) in the United States, components of the tax gap are “1) Nonfiling gap - the tax not paid on time associated with returns that are filed after the due date or not filed at all. 2) Underreporting gap - the additional tax due on timely filed returns arising from the misreporting of tax liability on those returns. 3) Underpayment gap - the tax that is reported on timely filed returns, but that is not paid on time.” The definition seems straightforward, but there are some difficulties applying it in practice. For instance, the amount of tax imposed by the tax code for a complex

multinational enterprise may not be obvious to the taxpayer, its advisers, and investors. There may be often a wide range of interpretations of tax law applied to complex economics of a multinational enterprise. It is common that these interpretations are different between the taxpayer and the tax administrator. Moreover, estimating the tax gap requires that high quality data be collected. Even the IRS does not yet have estimates of all components of the tax gap for a few types of taxes (Mazur & Plumley, 2007). In the United States, “the average annual tax gap for 2008-2010 is estimated to be \$458 billion”, and “the IRS enforcement activities and late payments resulted in an additional \$52 billion in tax paid, reducing the net tax gap for the 2008-2010 period to \$406 billion per year.” In other words, the tax gap is 19.4% of tax revenues.<sup>3</sup>

Unfortunately, South Korea has not calculated the tax gap yet, while the National Tax Service is proceeding the project for calculation of Korean tax gap. Also, other official data regarding tax compliance is not open in South Korea, unlike the United State in which the Taxpayer Compliance Measurement Program (TCMP) of the IRS is available and widely believed to be reliable information.

### **(3) Factors influencing compliance behavior**

The tax authority needs to reduce tax evasion in order to improve

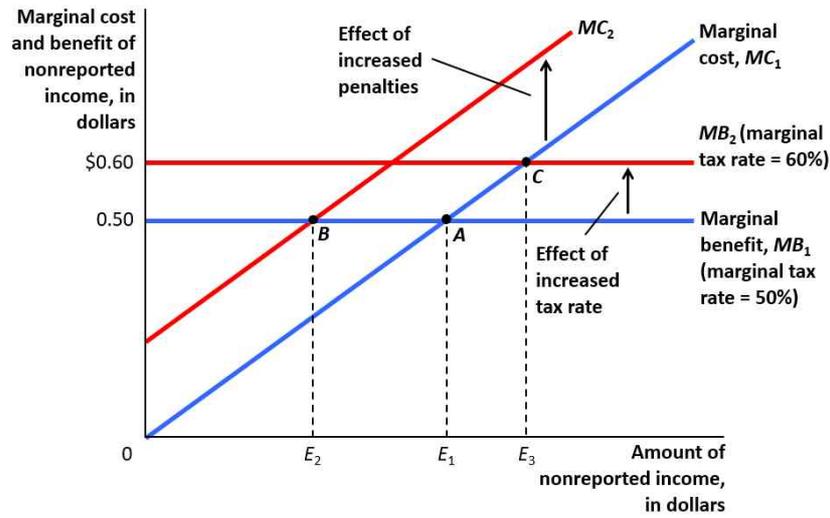
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<sup>3</sup> <https://www.irs.gov/uac/The-Tax-Gap>

tax compliance. There are two broad approaches to understand taxpayers' behavior. The first approach is based on an economic rationality perspective; people consider economic incentives and penalties when deciding tax compliance behavior. The economic model is useful but considered as oversimplified. The second approach deals with behavior issues from a psychology and sociology perspective. It considers many aspects influencing tax evasion other than economic factors.

The basic theory of tax evasion is based on economic analysis. There are two simple economic models explaining tax compliance and evasion. First, economists argue that individuals make economically rational decisions by considering its costs and benefits when they choose to evade taxes or not. The typical economic benefits of tax evasion are the amount of tax avoided. The classic economic costs of tax evasion are the risk of getting detected and the amount of penalties, fines, and related punishments. Specifically, the marginal benefit of tax evasion is the marginal tax rate faced by taxpayers, and the marginal cost of tax evasion is the marginal penalty (including all the related punishments) times the probability of getting detected. The optimal amount of evasion is determined at the point where the marginal benefits and the marginal costs coincide. The graph below shows the change of tax evasion behavior when the tax rate and penalties increase (Gruber, 2013).

**Figure 2. Economic model based on cost and benefit of tax evasion**



The weakness of this model is that it assumes individuals are risk-neutral. Another model taking individuals' attitude toward risk into account is the expected utility model of the income-reporting decision. Consider a taxpayer with income  $y$  faces a tax rate  $t$ . The taxpayer reports a number  $x$  to the government as his income and pay taxes  $tx$ . If the taxpayer is honest (fully compliant), he will report  $x = y$ . However, the taxpayer may report an income  $x$  that is smaller than  $y$  ( $x < y$ ). Let  $z = y - x$  be the amount by which income is under-reported. "The tax authority enforces compliance through a system of audits and penalties. Assume that the enforcement policy is to audit reports with a probability  $p$  ( $0 < p < 1$ ). As a result of an audit, we assume the tax authority always knows the true income  $y$ . If the taxpayer is caught cheating, he must pay a penalty  $\theta$  on each dollar of income evaded

(total penalties  $\theta z$ ), as well as the evaded tax. Consequently, if a taxpayer avoids an audit the taxpayer will have consumption (net income) of  $y - tx = y(1-t) + tz$ . On the other hand, if the taxpayer is audited, his consumption will decrease to  $y - tx - (\theta + t)z = y(1 - t) - \theta z$ . The expected utility of a taxpayer is  $EU = (1 - p)u[y(1-t) + tz] + pu[y(1 - t) - \theta z]$  (Andreoni, Erard, & Feinstein, 1998).

There are additional costs, as well as penalties. The complexity of tax system imposes direct and indirect costs on taxpayers when taxpayers pay to comply with obligations. The direct costs are compliance costs related to record keeping, preparing forms, audits, penalties, litigation, enforcement, collection, and so on (Hall & Rabushka, 1995). One research estimated the compliance cost of the individual income tax in the United States: in tax year 2000, “125.9 million individual taxpayers experienced a total compliance burden of 3.21 billion hours and \$18.8 billion. This translates into an average burden of 25.5 hours and \$149 per taxpayer” (Guyton, O’Hare, Stavrianos, & Toder). What’s more, taxpayers take on “co-operational” roles. In the value added tax system in South Korea, business entities need to receive tax invoice from sellers and issue tax invoice to buyers, and then they pay the residual value added tax. Moreover, in the year-end tax adjustment, corporations need to process the adjustment process on behalf of their employees. These cooperation costs can be huge particularly to small businesses.

The indirect costs are economic losses caused by tax, which are

called deadweight losses or excess burdens. The complicated tax system and high tax rates bring about the reduction in output, resulting in economic losses. Specifically, the federal income tax in the United States leads to reduction in labor supply, reduction in capital formation, investments designed to reduce taxes rather than produce income, tax avoidance, tax evasion, and so on. Many studies estimated the cost of raising one additional dollar. The cost ranges from 24 percent to 151 percent of taxes collected (Hall & Rabushka, 1995).

As well as economic factors, behavioral factors are important. Compliance behavior relies on individual differences in terms of age, gender, personality, industry, education level, personal tendency toward risk, and circumstances. If taxpayers believe that the current tax system is fair and they are treated fairly compared to others, for example, they are more likely to comply. However, if they perceive the unfairness of the system or experienced unjust practice, they would try to become non-compliant whenever possible. It is related to the confidence in and satisfaction with the government and tax authority. Additionally, individuals have different preferences toward risk. Individuals are risk averse, risk loving, or risk neutral. If some individuals are more risk loving than others, they perceive the risk of getting detected less important and are more likely to try to avoid taxes. Overall, the below table presents business, industry, sociological, economic, and psychological factors influencing the compliance behavior (OECD, 2004).

**Table 1. Various factors influencing the compliance behavior**

	<b>Generic characteristics</b>
Business	<ul style="list-style-type: none"> <li>· Structure – sole trader, partnership, company, trust</li> <li>· Size and age of the business</li> <li>· The type of activities it carries out</li> <li>· Focus – local versus international</li> <li>· Its financial data – capital investment</li> <li>· Its business intermediaries</li> </ul>
Industry	<ul style="list-style-type: none"> <li>· The definition / size of the industry</li> <li>· Major participants in the industry</li> <li>· Cost structures</li> <li>· Industry regulations</li> <li>· Industry issues such as levels of competition, seasonal factors and infrastructure issues</li> </ul>
Sociological	<ul style="list-style-type: none"> <li>· Cultural norms</li> <li>· Ethnic background</li> <li>· Attitude to government</li> <li>· Age, Gender</li> <li>· Educational level</li> </ul>
Economic	<ul style="list-style-type: none"> <li>· Investment</li> <li>· Demographic interest rates</li> <li>· The tax system</li> <li>· Government policies</li> <li>· International influence</li> <li>· Markets</li> </ul>
Psychological	<ul style="list-style-type: none"> <li>· Greed, Risk, Fear, Trust</li> <li>· Values</li> <li>· Fairness / Equity</li> <li>· Opportunity to evade</li> </ul>

A research in South Korea measured "perception of the underreporting of tax liability" and "perception of honest tax payments" as a proxy of taxpayers' compliance attitudes, based on "a taxpayer attitude survey conducted by the Korean Public Finance Institution in February 2007." Taxpayers with high income are more likely to regard the underreporting of tax liability as an acceptable behavior. In contrast, those

who consider tax return as an obligation have more tendency to disapprove of underreporting behavior. Additionally, "perception of honest tax payment" is higher for those who are married, more aged, and wage earners, whereas taxpayers with high income have lower level of "perception of honest tax payment" (Park & Shim, 2008).

Among factors influencing compliance behavior, the population in South Korea think that integrity of taxpayer him/herself is most important. The next is the proper amount of tax due commensurate to income and incentives for compliant taxpayers. The fear of tax audits and detection is reported to be relatively not important. In addition, people's perception that tax revenue is wasted is most important among factors influencing noncompliance behavior. The next is that compliant taxpayers have excessive liability due to noncompliant taxpayers. In these factors, the risk of getting detected is perceived as low. According to the survey data, income and education level is negatively related to "the Korean taxpayers' average tax attitude", which is the similar result as the previous research. Moreover, self-employed taxpayers have lower level of tax attitude. It is consistent with general expectations that they have incentives to hide cash-transactions and do not have enough capability to file tax returns faithfully. What's interesting is that better tax understanding is negatively related to compliance (Park, Kim, & Kweon, 2008). Although the government should provide enough information to taxpayers, the government should be careful in order to prevent taxpayers from abusing the system.

#### **(4) Effects of tax amnesty**

A tax amnesty offers taxpayers an opportunity to report voluntarily during a specified period of time and pay their legitimate taxes. The “carrot” encouraging participation is forgiveness of some penalties that might have been assessed on the unpaid taxes. There is also a “stick” – the promise of enhanced investigation for tax evasion and severer penalties after the amnesty. Considering individuals’ rational decision making, the amnesty could not make any substantial change without stepped-up detection efforts (Fisher, Goddeeris, & Young, 1989). Tax amnesties have controversial arguments about revenue effect. Their long-term impact on voluntary tax compliance is of particular concern. Advocates of tax amnesties contend that a one-time amnesty program may improve future voluntary compliance if it is accompanied by greater enforcement and penalties for evaders. Critics argue that the long-term consequences of an amnesty are likely to result in a negative impact on tax compliance. This is because compliant taxpayers may consider the amnesty as special benefit for tax evaders and most taxpayers may not believe that the government’s tax amnesty program is a one-time opportunity. Also, the responses to the introduction of offshore voluntary disclosure program are expected to depend on the degree of tax compliance of each taxpayer. Those who have a high compliance rate before the introduction of voluntary disclosure program are likely to continue to comply with the tax law. In contrast, those who comply not at all might not be positively affected by the tax amnesty program (Alm, Mckee, & Beck, 1990).

Optimistic views on impact of tax amnesty on tax compliance are found in literature. One research shows that tax compliance can increase when people have the opportunity to vote on a tax amnesty. The same tax amnesty experiment was conducted in Switzerland and Costa Rica, two countries with different historical and cultural backgrounds. The strongest effect can be achieved when public discussions are involved prior to votes. It seems that the voting procedures encourage “a sense of civic duty.” It suggests that incorporating the social norms into tax compliance model might be important to better understand why taxpayers comply with the tax administration (Torgler, Schaltegger, & Schaffner, 2003). Experimental evidence indicates that the overall level of tax compliance can fall after an amnesty because behavior of those engaged in moderate levels of compliance is affected. In this situation, however, negative impacts on compliance can be offset by greater post-amnesty enforcement efforts. Thus, the combination of an amnesty and enforcement can increase aggregate compliance. Also, implementing an amnesty and enhanced enforcement efforts together is more effective than changing enforcement efforts alone (Alm, McKee, & Beck, 1990). Based on individual taxpayer-level data from participants in Michigan's amnesty program (1986), the amnesty's impact on revenues appears negligible. However, it appears to have succeeded in keeping a sizable number in the system, at least shortly after the amnesty. Moreover, the amnesty participants who stayed in the system have higher incomes and prepaid most of their taxes. It seems that the state's threat of stepped-up enforcement may have been credible (Christian, Gupta, & Young, 2002). Although the additional revenue appears marginal, this result can be

considered as positive because bringing taxpayers back to the system is one of major objectives of offshore voluntary disclosure program.

On the other hand, offshore voluntary disclosure program may have little effect on tax compliance. The empirical results from time series methods indicate that a tax amnesty, the 1985 Colorado amnesty, did not reveal long run impact on the trend or the level of tax collections. This result shows that a typical amnesty is unlikely to create new revenues substantially, but also unlikely to deteriorate voluntary tax compliance. Unfortunately, this consequence may have several possibilities. Considering the greater enforcement efforts after the amnesty, the amnesty itself might have had compliance-reducing effects, and the greater enforcement effects might have offset the negative effect (Alm & Beck, 1993). A 1986 Michigan amnesty suggests that the amnesty may be ineffective to identify tax evaders and turn them into compliant taxpayers. The long-term additional revenue coming from new taxpayers brought into the system is likely to be small. It also might be offset if amnesty has any negative effects on the compliance behavior of other taxpayers. However, revenue comes sooner even though it could have been collected later, and it comes at lower compliance cost than it would have with greater enforcement efforts alone (Fisher, Goddeeris, & Young, 1989).

Pessimistic views show that amnesties are unlikely to generate significant revenues and they have possibilities to deteriorate the credibility of the tax authority and reduce tax compliance. On the other hand, the success of amnesties relies on a quick and convincing change in the tax

authority's behavior, which results in an effect change in the public's beliefs. It requires the existence of an efficient tax authority; most developing countries do not have it (Stella, 1991). It is found that a tax amnesty for the first time produces a short-term increase in revenue during the amnesty period. However, it leads to a revenue decrease in the long-run. Repeated amnesties produce little or no additional revenue even in the short-run. At the same time, they reduce compliance and cause revenue losses in the long-run. Therefore, even the first amnesty does not guarantee long-run revenue increase, and the state should avoid repeated tax amnesties (Luitel & Sobel, 2007).

One study shows that the existence of voluntary disclosure program increases tax evasion, according to the theoretical model. At the same time, the introduction of 2009 voluntary disclosure program in the United States reveals this effect empirically. Nonetheless, a voluntary disclosure program can be a useful tool for a revenue-maximizing government because it can increase net tax revenues without increasing administrative costs for prosecuting tax evaders. The study also found that administrative costs in Germany are significant (Langenmayr, 2014). When introducing rewards in tax evasion model, increasing penalties for tax evasion and offering benefits for payment of taxes improves a taxpayer's utility without deteriorating the total revenue of the government. Thus, rewards for paid taxes can guarantee the increase of the government revenue and the taxpayer's utility (Falkinger & Walther, 1991).

As discussed above, there is no consistent answer to the effect of

offshore voluntary disclosure program on tax compliance and revenue. Moreover, the level of compliance and the change in compliance in response to policy changes differ across countries (Alm, Sanchez, & De Juan, 1995). Most studies in South Korea predict that operating offshore voluntary disclosure program temporarily can be helpful to induce voluntary compliance quickly, reduce tax evasion, and secure short-term increases in tax revenue. Although the tax administration will eventually detect offshore tax evasion as international cooperation expands, the offshore voluntary disclosure program can facilitate the process and alleviate the anxiety of taxpayers (Park, 2014). Voluntary disclosure program gives taxpayers an opportunity to correct past errors without big costs. Voluntary disclosure program can decrease both administration costs of the tax authority and compliance of costs of taxpayers. According to the Framework Act on National Taxes, penalty reduction caused by voluntarily amendment varies on time elapsed from the right timing. However, there is no regulation after two years have passed away from the right timing. In case of delayed return, there is no regulation after six months passed away from the right timing. The tax law should be amended to reduce penalties for voluntarily amendment and delayed return, even if they were submitted after two years or six months from the right timing. In addition, integrity requirements are necessary which require taxpayers to provide complete information when they amend their tax returns. If taxpayers amend previous filings based on incomplete information, penalty reduction is not justified. Moreover, evasion of Value Added Tax should be treated as severer than other tax items since it embezzles the wealth of a third party (Kim, 2015).

## **(5) Principles for successful voluntary disclosure programs (OECD, 2015b)<sup>4</sup>**

Although each individual country should take into account its tax law and practice and other circumstances, OECD has developed principles for successful offshore voluntary compliance programs. They are based on the experiences of OECD countries and consultations with external parties. The principles are based on a wider tax compliance strategy. Although they are not absolute standards for offshore voluntary disclosure program, they can be one of tools used to evaluate and improve the program.

First, a successful program should “be clear about its aims and its terms.” Its aims and terms should be unambiguously made in the first place. They need to be available to both to the eligible taxpayers and to others. This principle is necessary to avoid any ambiguity regarding the program and any doubt about the even-handedness of the government. Also, it should be evident how the government treat the disclosure under the program for anti-money-laundering purposes. According to OECD, the aims are generally “1) to improve short-term tax revenues cost-efficiently, 2) to improve long-term tax compliance, and 3) to encourage repatriation of capital.” To achieve these aims, offshore voluntary disclosure program is recommended to have a broad scope, to be available to all population, and to include all kinds of taxes. Protecting from criminal prosecution is also

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<sup>4</sup> The explanation in this section cited and summarized “Update on Voluntary Disclosure Programmes: A Pathway to Tax Compliance” by OECD.

suggested.

Second, a successful program should “deliver demonstrable and cost-effective increases in current tax revenues.” The aims of most programs include cost-efficient short-term revenues improvement. This aim should be demonstrable. Specifically, the government needs to calculate revenue gains and the related costs. Without the program, taxpayers might report their offshore income and/or assets or the tax authority might find them based on the increased financial information. The government should be able to demonstrate that revenues gains from the program are more cost-efficient than the status quo. It is a hard task. However, disclosing net benefits to the public can justify the program and reassure compliant taxpayers that the program is also beneficial to them.

Third, a successful program should “be consistent with the generally applicable compliance and enforcement regime.” The short-term objective of the program is to increase tax revenues cost-efficiently by providing taxpayers holding offshore income and/or assets. The difficulty in dealing with the program is that the short-term objective might obstruct the long-term tax compliance, which is an important long-term objective of the program. In spite of offshore voluntary disclosure program, keeping with ongoing compliance and enforcement procedures is necessary. It can prevent from taxpayers to manipulate the program. For example, some programs collect the full amount of tax on previously undisclosed income.

Forth, a successful program should “help to deter non-compliance.” Although all the principles are interrelated to each other, this principle is

particularly connected with the third principle. The government needs to show its ability to detect non-compliance activities. When the public thinks that the government has the capability to deal with offshore tax evaders, the program would be attractive to previously non-compliant taxpayers and not harm general compliance levels. In addition, the tax administration should treat those who stay in non-compliant after the program more severely than those who take advantage of the program. For example, penalties, fines, and criminal prosecution should be higher for non-compliant taxpayers.

Fifth, a successful program should “improve levels of compliance among the population eligible for the program.” The possibility of detecting offshore income and/or assets has been increasing due to information exchange among countries. Thus, taxpayers gave a greater incentive to disclosure voluntarily. Offshore voluntary disclosure program should support this trend. In this regard, the tax authority should increase the risk of detecting those who choose not to participate in the program. Also, the program should be able to provide an incentive for those are eligible for the program. After all, this principle is related to the third and the forth principle. Credible enforcement measures can tackle tax evaders and, thus, are an essential prerequisite for the success of the program. To show the tax authority’s will and capability, exemplary prosecution of those who do not participate in the program or try to abuse the program is suggested. In addition, it should be made easy for taxpayers who are eligible for the program to take part in the program.

Sixth, a successful program should “complement the immediate

yield from disclosures with measures that improve compliance in the long-term.” The risk of the program is that it might harm overall compliance behavior. Long-term compliance is more important than short-term revenues increases. The program should not give taxpayers an incentive to manipulate the program. When the country repeats a temporary program or change it to a permanent program, credibility of the program can be damaged, and careful strategy is necessary. A number of programs are implemented with other measures to avoid damaging long-term compliance. For example, some programs were introduced with changes in international tax environment such as the introduction of automatic exchange of information and changes to double tax conventions. Other programs started when new powers took in legislation or tougher penalties were applied after the program. For most compliant taxpayers, there is no incentive to change their behavior. For the deliberately non-compliant taxpayers, the program does not reinforce benefit of tax evasion and does provide an incentive to participate in the program.

### **3. Offshore Voluntary Disclosure Program in Korea**

#### **(1) History**

The government implemented the Offshore Voluntary Disclosure Program on 1 September 2015 for the first time and for one-time. There were tax amnesties in the past, although they were not directly intended for offshore voluntary disclosure. Moreover, besides the Offshore Voluntary Disclosure Program as a special program, there are general programs: Revised Return and Return after Term. The Foreign Financial Accounts Reporting is not an incentive program; instead, it forces taxpayers to report financial accounts information registered in foreign countries. However, it is closely related to the Offshore Voluntary Disclosure Program in that it mandates overseas financial accounts to be reported.

In 1961, a special act exempted criminal prosecution for tax evaders. The act was to stimulate entrepreneurship and stabilize the national economy. It did not require the application of taxpayers and was the national policy for the entire population. Although it exempted original tax due, there were exceptions for some tax evaders. In 1993, the government implemented the real-name financial transaction system. For the success of this institution, the government needed to alleviate anxiety for tax audit. The tax authority did not investigate the source of funds related to real-name conversion and levy tax based on the funds (Park, 2014).

## **(2) General program**

Taxpayers may file a revised return within the statutory due date of return or file the return of tax base after the term. Taxpayers are eligible to receive the reduction of penalties since they make things right voluntarily.

First, when a taxpayer “has filed a written return of tax base within the statutory due date of return, the taxpayer may file a revised return until the tax authority determines or corrects and notifies the tax base and the amount of taxes” (Framework Act on National Taxes, Article 45). In other words, the government reduces penalty taxes when the underreporting is amended. The proportion of the penalty waive varies depending on when the amended tax return is filed. “When the taxpayer files an amended tax return within 6 months after the statutory due date, the penalty taxes are reduced by 50%. When the return is filed after 6 months and within 1 year, the penalty taxes are reduced by 20%. Finally, when the return is filed after 1 year and within 2 years, the penalty taxes are reduced by 10%” (Framework Act on National Taxes, Article 48).

Second, “a taxpayer may file the return of tax base after the term before the tax authority notifies tax base and tax amount. The taxpayer should pay the amount of taxes when filing the return” (Framework Act on National Taxes, Article 45-3). It grants an opportunity for a taxpayer who fails to file a return within the statutory due date to make things right voluntarily. “When a taxpayer files a return within one month after the statutory due date, the tax authority reduces the penalty taxes by 50%. If the

taxpayer files a tax return within 6 months after the statutory due date, the penalty taxes are reduced by 20%” (Framework Act on National Taxes, Article 48).

**Table 2. Structure of general program**

<b>Case</b>	<b>From the statutory filing date</b>	<b>Penalty reduction proportion</b>
In case of underreporting	~ 6 months	50%
	6 months ~ 1 year	20%
	1 year ~ 2 years	10%
In case of no tax return	~ 1 month	50%
	1 month ~ 6 months	20%

In case of criminal punishment, when a taxpayer makes a modified return on tax evasion, the punishment may be reduced. Specifically, “when the taxpayer files a tax return within 6 months or amends return within 2 years after the statutory due date, imprisonment period may be reduced. If the amended return is submitted after 6 months or 2 years from the right timing, the reduction of penalty taxes or criminal punishment is not given” (Punishment of Tax Evaders Act, Article 3).

### **(3) Foreign Financial Accounts Reporting<sup>5</sup>**

From June 2011, residents or domestic corporations must file information on overseas financial accounts if the accounts are opened at overseas financial companies and “the aggregate balance exceeds KRW one billion for any last day of a month of the relevant year.”

Subjects for the reporting are residents and domestic corporations. A resident means an “individual who has his/her domicile in Korea or a place of residence for 1 year or more in Korea.” If the account is owned by joint owners, all of the owners should report. If the nominal owner of an account is different from the actual owner of the account, both individuals need to report. Objects for disclosure are “any bank, securities, securities derivatives or other financial instruments accounts which are opened in the name of an overseas financial company.” All assets in the accounts are subject to reporting. Taxpayers should report “i) information on the identity of the account holder, such as name, address, etc. ii) information on the account held, such as account number, name of the financial company, the highest amount of the remaining balance of the account on the last day of each month. iii) information on a person related to the overseas financial

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<sup>5</sup> The explanation for Foreign Financial Accounts Reporting in this section cited a publication written by National Tax Service regarding Foreign Financial Accounts Reporting, [http://nts.go.kr/info/info\\_04\\_04.asp?type=V&minfoKey=MINF7420080211211649&mbsinfoKey=MBS20140523160357257#](http://nts.go.kr/info/info_04_04.asp?type=V&minfoKey=MINF7420080211211649&mbsinfoKey=MBS20140523160357257#).

account.<sup>6</sup>”

“Taxpayers subject to reporting should file the 「Report of Foreign Financial Accounts」 to the competent tax office in June.” “Non-reporting or under-reporting will result in a penalty of up to 10% of the undisclosed amount.” “If the amount of non-reporting or under-reporting exceeds KRW 5 billion, the tax authority may make public personal information of violators, such as name, age, occupation, address, the amount of violation, etc. Moreover, violators are subject to criminal punishment, imprisonment under 2 years or fines under 10% of the amount of violation.”

The penalty can be reduced by amending reporting and submitting reporting after the term. According to the general program, the taxpayer may file a revised return. When the return is filed within 2 years, the penalty taxes are reduced by 10% ~ 50%. In case of the Foreign Financial Accounts Reporting, the benefit is better. It does not distinguish between filing a revised return and filing a return after the term. When a taxpayer files a reporting within 4 years, the penalties are reduced by 10% ~ 70%.

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<sup>6</sup> “A related person refers to the nominal and actual owners in cases of an account, etc. among the overseas financial accounts whose nominal holder and actual owner are different, and each of respective persons under a joint name in cases of a joint checking account.”

**Table 3. Penalties on non-reporting of foreign financial accounts**

<b>The amount of underreporting (KRW)</b>	<b>Penalty rate (%)</b>
~ 2 billion	4%
2 billion ~ 5 billion	7% (only for the amount over 2 billion)
5 billion ~	10% (only for the amount over 5 billion)

**Table 4. Benefits for voluntary correction**

<b>Timing from the statutory due date</b>	<b>Reduction rate</b>
~ 6 months	70%
6 months ~ 1 year	50%
1 year ~ 2 years	20%
2 years ~ 4 years	10%

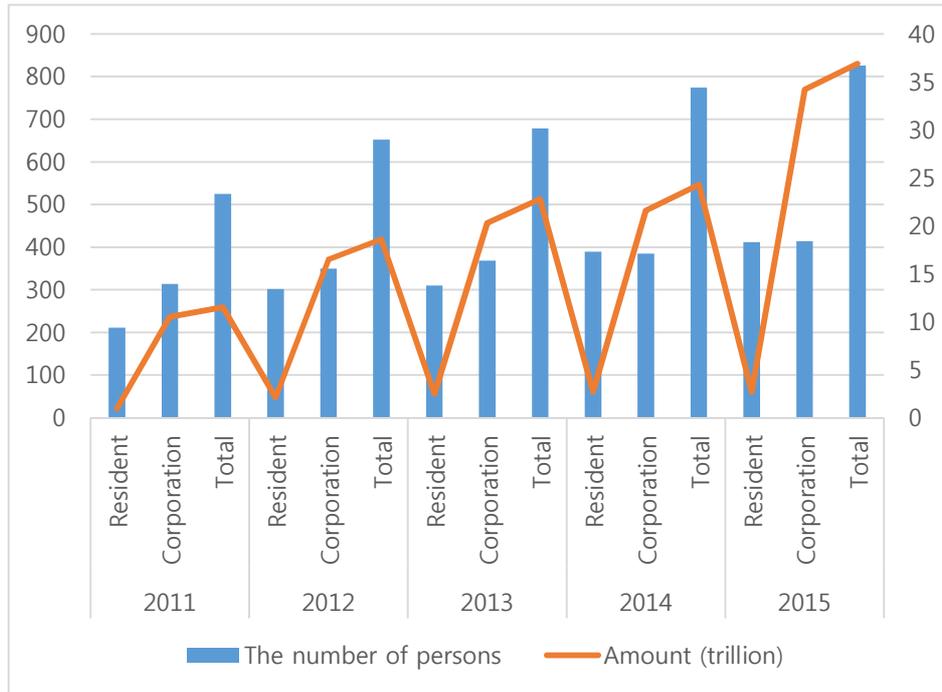
The benefit for voluntary correction was the same as general program; when reporting was filed within 2 years, the penalty was reduced by 10% ~ 50%. Since 2015, the benefit has significantly increased; both the eligible term and the rate of reduction increase and, thus, when a taxpayer files a reporting within 4 years, the penalties are reduced by 10% ~ 70%. In addition, the fine and penalty will increase from 2016. When the government introduced the Foreign Financial Accounts Reporting in 2011, it reduced the penalty for non-reporting or under-reporting from 10% to 5%. In addition, when the regulation for criminal punishment was created in the 2013 law revision, it was applied from 2014 (Park, 2014).

The number of persons reporting and the amount of reported money have been steadily increasing.

**Table 5. Results of the Foreign Financial Accounts Reporting**

<b>Year</b>	<b>Subject</b>	<b>The number of persons</b>	<b>The number of accounts</b>	<b>Amount (trillion)</b>
2011	Total	525	5,231	11.5
	Resident	211	768	0.97
	Corporation	314	4,463	10.5
2012	Total	652	5,949	18.6
	Resident	302	1,059	2.1
	Corporation	350	4,890	16.5
2013	Total	678	6,7128	22.8
	Resident	310	1,124	2.5
	Corporation	368	5,594	20.3
2014	Total	774	7,905	24.3
	Resident	389	1,574	2.7
	Corporation	385	6,331	21.6
2015	Total	826	8,337	36.9
	Resident	412	1,593	2.7
	Corporation	414	6,744	34.2

**Figure 3. Results of the Foreign Financial Accounts Reporting**



#### **(4) Offshore Voluntary Disclosure Program**

##### **1) History**

The National Assembly modified “Adjustment of International Taxes Act” on 23 December 2014. Based on this act, the Minister of Strategy and Finance may, at the request of the Commissioner of the National Tax Service, execute Offshore Voluntary Disclosure Program. The act specified that the program might set a specific period only on one

occasion. Although it was an important modification, it did not receive attention from the media and the public at that time.

The Minister of Strategy and Finance with the Minister of Justice implemented the Offshore Voluntary Disclosure Program on 1 September 2015. Although the program seemed not to draw much attention from the media, this indifference might be desirable for the government, considering that the program might be seen as a privilege for the rich. Nonetheless, those with offshore income and/or assets would get to know this issue well since they have a keen interest in tax issues.

The Minister of Strategy and Finance made Secretariat of Offshore Voluntary Disclosure Initiative in the Minister of Strategy and Finance on 17 September 2015. The program was executed from 1 October 2015 to 31 March 2016. As well as the Minister of Strategy and Finance, the National Tax Service announced Offshore Voluntary Disclosure Program in a press release on 22 September 2015. In addition, the National Tax Service made the office for the Program at six Regional Tax Offices and encouraged those with offshore income and/or assets to use this program.

## **2) Eligibility**

The Offshore Voluntary Disclosure Program gives taxpayers the opportunity to report undisclosed offshore income and/or assets. Taxpayers should pay taxes during the voluntary disclosure period from 1 October 2015 to 31 March 2016. Residents and domestic corporations are eligible

for this program. Residents mean “any individual who has his/her domicile or has his/her place of residence in the Republic of Korea for not less than one year” (Income Tax Act, Article 1-2). Domestic corporations mean “corporations with its headquarters, main office or actual business management place located in the Republic of Korea” (Corporate Tax Act, Article 1).

However, a taxpayer is ineligible if the taxpayer is likely to be imposed taxes or punished as a consequence of tax audit and investigation regarding the income and/or assets that the taxpayer is going to report. If tax audit or relevant investigation were initiated for some items of tax or income and/or assets, other items of tax, other income and/or assets, and other tax belonging to different tax years are eligible for reporting. For checking the eligibility, taxpayers can request for “prequalification-screening” by 31 January 2016 to the Secretariat of Offshore Voluntary Disclosure Initiative, Ministry of Strategy and Finance. They will be notified of the eligibility within one month from the date of request (Ministry of Strategy and Finance, 2015).

There is limitation period for national tax assessment. It is the period for excluding levy of national tax (Framework Act on National Taxes, Article 26-2). No national tax may be levied after the limitation period. The period varies from 1 year to 15 years. Therefore, if taxpayers have offshore accounts, income, and/or assets that are unreported or underreported and the period does not expire the limitation period, the taxpayers are eligible.

**Table 6. Limitation period**

Category		Period
General tax item	When evading any national tax by fraudulent or other unlawful means	10 years
	When failing to file a return of tax base within the statutory due date of return	7 years
	Other cases	5 years
Inheritance tax Gift tax	1) When evading any national tax by fraudulent or other unlawful means	15 years
	2) When failing to file a return of tax base within the statutory due date of return	
	3) When having any false statement or omission in the return	
	Other cases	10 years
	When an inherited or gifted property located overseas	1 year  (from the date on which the inheritance or gift of the relevant property is known)

### 3) Benefits

First, “a program participant is waived from penalties under the tax laws.” Penalty taxes are imposed in case of violating obligations prescribed in tax-related Acts. There are “Penalty Taxes on Non-Filing”, “Penalty Taxes for Underreporting or Penalty Taxes for Over-Refunding Return”, “Penalty Taxes for Insincere Payment and Refunding Return”, and “Penalty Taxes for Insincere Payment of Withholding Tax.” However, “Penalty Taxes

for Insincere Payment and Refunding Return” are excluded from benefits of the program since they have the characteristic of interest for arrears.

Second, “a program participant is waived from fines under the tax laws and/or the Foreign Exchange Transactions Act.” The Foreign Exchange Transactions Act is “to facilitate foreign transactions, to maintain equilibrium in the balance of international payments and to stabilize the value of currency by ensuring liberalization of foreign exchange transactions and of other foreign transactions, and by revitalizing market functionality” (Foreign Exchange Transactions Act, Article 1). Under the law, there are many cases subject to fines. For example, “when failing to submit data or having submitted false data, having paid, received or moved funds in violation of the procedures for payment, and having transacted capital without filing a report” (Foreign Exchange Transactions Act, Article 32).

Third, a voluntary disclosure program participant receive lenient treatment on criminal acts related to the formation of offshore income and/or assets. The criminal acts include tax evasion and the violation of foreign exchange transactions reporting. The reason why taxpayers will be given lenient treatment is that the government is going to deem voluntary disclosure as self-denunciation under the criminal law. Therefore, criminal punishment can be mitigated (Ministry of Strategy and Finance, 2015).

The government clearly states that this Offshore Voluntary Disclosure Program offers taxpayers only one-time chance to correct things voluntarily with benefits. Moreover, the government guarantees the confidentiality of tax information taxpayers submit.

#### **4) Comparison with general program**

It is common that taxpayers file a return for undisclosed income after the statutory due date. However, the object of Offshore Voluntary Disclosure Program is offshore income and/or assets. On the other hand, the object of general program is all tax base including domestic and offshore income and/or assets. Moreover, the subject of Offshore Voluntary Disclosure Program is resident or domestic corporation. On the other hand, the subject of general program is all taxpayer.

General program reduces penalty taxes and imprisonment period. Offshore Voluntary Disclosure Program “exempts” penalty taxes. Total exemption is much more advantageous than reducing just 10% ~ 50%. Offshore Voluntary Disclosure Program also exempts penalties from other laws: Foreign Exchange Transactions Act and the Foreign Financial Accounts Reporting. Also, a participant in the program can avoid from being made public by the Foreign Financial Accounts Reporting. Regarding criminal punishment, a program participant is granted lenient treatment on criminal acts related to the formation of offshore income and/or assets.

## **(5) Specific programs in major countries**

### **1) Report of Foreign Bank and Financial Accounts in the United States**

If United States persons have “a financial interest in or signature authority over a foreign financial account (including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account), exceeding a certain amount of thresholds, the Bank Secrecy Act may require them to report the account each year to the Department of Treasury by filing a Financial Crimes Enforcement Network (FinCEN) 114 and Report of Foreign Bank and Financial Accounts (FBAR).<sup>7</sup>”

United States persons are required to file an FBAR if “i) the United States person had a financial interest in or signature authority over at least one financial account located outside of the United States; and ii) the aggregate value of all foreign financial accounts exceeded \$10,000 at any time during the calendar year reported.” “A person holding a foreign financial account may have an obligation to report even when the account produces no taxable income.” “The reporting obligation is met by answering questions on a tax return about foreign accounts and by filing an FBAR.” A financial account includes, but is not limited to, securities, brokerage, savings, demand, checking, deposit, time deposit, or other account

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<sup>7</sup> <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Report-of-Foreign-Bank-and-Financial-Accounts-FBAR>

maintained with a financial institution. If a person is required to file an FBAR and fails to file it properly, the person may be subject to a civil penalty which does not exceed \$10,000 per violation. When there is justifiable reason for the failure and the account balance is correctly reported, the penalty will not be imposed. A person who intentionally fails to report an account or account identifying information may be subject to a civil monetary penalty equal to “the greater of \$100,000 or 50 percent of the balance in the account at the time of the violation.” Civil and Criminal Penalties may be imposed together.<sup>8</sup>

## **2) Offshore Voluntary Disclosure Program in the United States**

The IRS voluntary disclosure program offers a way for taxpayers with previously undisclosed income to contact the Internal Revenue Service (IRS) and settle their tax issues. The program does not apply to taxpayers whose income is originated from illegal activities. Although the voluntary disclosure practice is a longstanding practice of IRS, taxpayers with undisclosed offshore assets or incomes will fall under this special program.

Tackling offshore tax evasion and bringing taxpayers, especially high income earners, back into the legitimate tax system is a top priority of IRS. IRS offshore voluntary disclosure programs are created to persuade taxpayers with previously undisclosed offshore assets to report their tax

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<sup>8</sup> Ibid.

liabilities. The programs are part of a wider enforcement effort to deter offshore tax evasion. The effort includes enhanced enforcement, criminal prosecutions and implementation of third-party reporting via the Foreign Account Tax Compliance Act (FATCA).<sup>9</sup>

There have been three voluntary disclosure programs: 2009 OVDP, 2011 OVDI, and 2012 OVDP. Overall, the three voluntary programs have resulted in more than 45,000 voluntary disclosures from individuals, and they have paid about \$6.5 billion in back taxes, interest and penalties. The IRS announced the 2009 Offshore Voluntary Disclosure Program (OVDP) in March 2009. It provided taxpayers with an opportunity to avoid civil and criminal penalties, including criminal prosecution, in the form of single miscellaneous offshore penalty. The 2009 OVDP was based on longstanding voluntary disclosure practices of IRS Criminal Investigation. Overall, the offshore penalty was 20 percent of the highest aggregate value of the unreported offshore assets from 2003 to 2008. Participants were also required to file amended or late returns and FBARs for those years. Attention in mass media associated with U.S. enforcement efforts against certain foreign banks led to strong demand of this voluntary program. In the 2009 OVDP the IRS received 15,000 disclosures until 15 Oct, closing date that year. The monetary result was the collection of \$3.4 billion in back taxes, interest and penalties. Another 3,000 disclosures also followed after

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<sup>9</sup> <https://www.irs.gov/uac/newsroom/irs-offshore-voluntary-disclosure-efforts-produce-6-5-billion-45-000-taxpayers-participate>

the closing date.<sup>10</sup>

The 2009 program caused a lot of disclosures and helped the investigation of many individuals and financial institutions that furthered non-compliance with U.S. tax laws. As these investigations progressed, tax practitioners requested that additional individuals be offered an opportunity to come forward and voluntarily report their offshore accounts. The IRS responded the request, and the IRS announced the 2011 Offshore Voluntary Disclosure Initiative (OVDI) in February 2011, which lasted until September 9 of that year. Overall, participants of this program paid a 25 percent miscellaneous offshore penalty on the highest aggregate value of unreported offshore assets from 2003 to 2010. Some participants were eligible for special penalties, 5 percent or 12.5 percent, depending on the seriousness of their noncompliance behavior. The 2011 OVDI made 15,000 disclosures and brought about the collection of \$1.6 billion in back taxes, interest and penalties.<sup>11</sup>

Strong interest by taxpayers and tax professionals continued after the two prior voluntary programs, which led to a third program. For the third program, the IRS revised the terms of the 2011 OVDI program and set it permanent until further notice in January 2012. Though the 2012 OVDP has a higher penalty rate than the previous programs, it provides enough benefits to encourage taxpayers to report foreign accounts rather than risk

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<sup>10</sup> Ibid.

<sup>11</sup> Ibid.

detection and possible criminal prosecution. In the 2012 Offshore Voluntary Disclosure Program, participants pay a 27.5 percent penalty of the highest aggregate value of unreported offshore assets during the prior eight years. The 5 or 12.5 percent special penalties remained in effect for certain taxpayers. In June 2012, the IRS added an option to the 2012 OVDP that enabled some U.S. citizens and others residing overseas to satisfy their filing requirements and avoid huge penalties if they owed little or no back taxes. This option took effect in September 2012. This 2012 program has resulted in 12,000 disclosures since its initiation.<sup>12</sup>

The 2014 OVDP is a continuation of the 2012 program with modified terms. The IRS's prior programs have demonstrated the importance of consistent penalty structures for taxpayers who correct things voluntarily and report their undisclosed foreign assets. Because the implementation of the Foreign Account Tax Compliance Act (FATCA) and offshore enforcement efforts continue to increase the risk of detection of taxpayers with undisclosed foreign assets, the 2012 OVDP is necessary to give taxpayers who want to voluntarily disclose their offshore assets the opportunity to avoid criminal prosecution and limit civil penalties. Although the 2014 OVDP does not have deadline to apply, unlike the 2009 OVDP and the 2011 OVDI, the terms of this program could alter at any time. For instance, the authority may increase penalties, change eligibility, or

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<sup>12</sup> Ibid.

terminate the program at any time.<sup>13</sup>

### **3) Worldwide Disclosure Facility in the United Kingdom<sup>14</sup>**

The Worldwide Disclosure Facility (WDF) opened on 5 September 2016. After 30 September 2018, new enforcement regime under Requirement to Correct will initiate that reflect HM Revenue and Customs (HMRC)'s toughening approach. The United Kingdom stated that the OECD Common Reporting Standard (CRS) would significantly improve international tax transparency. The government says that it gives the final chance to come forward before it uses CRS data and strengthens the approach to offshore non-compliance.

Anyone who wants to report a UK tax liability that relates to offshore assets or income can participate in the facility. Taxpayers are required to make a complete disclosure of all previously undisclosed tax liabilities and calculate interest and penalties based on the current legislation. If taxpayers' disclosure is complete and correct and taxpayers fully cooperate by reporting any further information, the government will not try to impose a higher penalty. However, if taxpayers do not make a complete or honest disclosure or refuse to submit additional information, the tax

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<sup>13</sup> <https://www.irs.gov/individuals/international-taxpayers/offshore-voluntary-disclosure-program-frequently-asked-questions-and-answers-2012-revised>, #1

<sup>14</sup> <https://www.gov.uk/guidance/worldwide-disclosure-facility-make-a-disclosure>

authority may “i) apply a higher penalty, ii) open a civil or criminal investigation, iii) publish taxpayers’ details on the HMRC website.”

In addition, HMRC will handle disclosures differently and may impose a higher penalty when “i) taxpayers are already under enquiry by HMRC, ii) disclosure is connected to a previous inaccurate disclosure or settlement following an investigation, iii) taxpayers don’t follow the existing legislation on calculating penalties.”

#### **4) Other countries’ voluntary disclosure programs**

Other than the United States and the United Kingdom, there are interesting features of offshore voluntary disclosure programs in 47 countries. When taxpayers do not make timely and comprehensive filing and are detected by the tax authority, they have to pay the amount of tax evaded and interest on that amount and face criminal prosecution and imprisonment. Interestingly, two countries increase the tax rate or tax base for non-compliant taxpayers. Poland applies 75% tax rate to the income. Iceland increases the tax base by 25% and levies a monetary penalty of at least 200% of the undisclosed income. Moreover, there are large differences in monetary penalties. Poland uses 75% tax rate, and all other countries have separate monetary penalties. Monetary penalties can be a flat rate (e.g. Czech Republic, 20%), a range of the unpaid taxes (e.g. Belgium, 10% ~ 200%), and fixed amounts provided in the law (e.g. Croatia and Estonia). Differences in penalty rates are also significant. Penalty rates can be below

50% of the unpaid tax and above double the amount of undeclared income. Practically, countries often impose penalties at the lower end of the range when it is a taxpayer's first offence. Also, some countries with lower penalty rates levy a relatively high interest on tax evaded. On the other hand, some countries have monetary penalties that can exceed the original undeclared income and, thus, they have high penalties for non-compliant taxpayers when detected by the tax authority. In most countries, non-compliant taxpayers can avoid imprisonment through voluntary disclosure. It is possible under general programs or temporary programs. Although taxpayers in a few countries face the possibility of imprisonment, most of these countries consider the voluntary disclosure as a mitigating circumstances (OECD, 2015b).

## **4. Implications of Offshore Voluntary Disclosure Program in the Korean Context**

### **(1) The necessity of Offshore Voluntary Disclosure Program**

Operating offshore voluntary disclosure program should have reasonable grounds because the program is an unusual institution that provides non-compliant taxpayers with incentives to come forward. The government needs additional tax revenue in order to cover recent budget deficits and secure funds for income redistribution and social welfare spending. The government is also requested to deal with offshore tax evasion more firmly because enormous assets are alleged to be hidden in tax havens and this situation harms equity of the tax system. However, a single country has a limited capability to deal with offshore tax evasion and, thus, a new tool is necessary. Offshore voluntary disclosure program may become a troubleshooter in this situation.

A recent consecutive 3-year (2012-2014) deficit in tax revenue has limited flexible fiscal management. In 2013, specifically, the deficit of income tax was 3.9% of the budget. The deficits of corporate tax and value added tax was 4.6% and 1.1% of the budget, respectively. Considering that the Korean economy is projected to improve gradually in the future, fiscal policies for now need to focus on the execution of budgetary spending as planned and not to implement additional responsive measure. In the face of

unfavorable conditions in tax revenue, a simultaneous achievement of two goals of fiscal response and prudence requires drastic expenditure restructuring to precipitate structural reform and enhance resource allocation efficiency. A repetition of a tax revenue deficit must be avoided by improving the budget forecast and seeking out methods at various angles to expand tax sources (KDI, 2015).

In addition, there are political demand for redistribution and social welfare spending. The problem is that the increase in income tax or other taxes is politically unpopular. According to the Additional Survey of 2007 Korea Welfare Panel Survey, the survey result reveals Koreans' inconsistent and contradictory welfare attitude, concerning the government's responsibility on economic redistribution, social welfare, and taxation. Specifically, about 75% of the respondents agreed with the government's responsibility on economic redistribution, whereas only about 40% of the respondents agreed with an increase in tax for social welfare (Kim & Yeo, 2011). Consequently, the government is looking for the method to raise tax revenue without increasing tax rates.

In this contradictory situation, the tax authority should first broaden tax base by lighting on shadow economy. One of major shadow economy areas is offshore tax evasion. The government needs to broaden tax base and improve taxation equity between domestic and offshore income. Offshore tax evasion is increasing and becoming complicated. The amount of offshore tax evasion is alleged to be tremendous, and the hidden assets and incomes uncovered by tax authorities are also supposed to be the tip of

iceberg. The National Tax Service announced that it has uncovered 211 cases of offshore tax evasion in 2013, whose tax payment is 1,789 billion won. However, tax appeals were found to have been raised regarding 36 cases, 582.5 billion won. It is 17% of total cases in regard to the number of cases and 54% of total cases in regard to the amount of tax payment.<sup>15</sup> These tax appeals show that tax audits for offshore tax evasion have trouble making real tax revenue. Finding offshore tax evasions is a difficult job, but collecting money from them is a more demanding job. Confronting this difficult situation, many countries introduced offshore voluntary disclosure programs and they have achieved significant effects. For example, 447 million euro in 2007 in the United Kingdom, 496 million euro in 2004 in Belgium, 6,641 million euro in 2003 in the Republic of South Africa, and 2,100 million euro in 2002~2003 in Italy (Park, 2014). Offshore voluntary disclosure program looks attractive to the government, considering difficulties in tackling offshore tax evasion and successful cases in foreign countries.

Voluntary disclosure programs could be general and permanent programs or temporary initiatives. The choice between two types depends on the objective of the program. Temporary program is generally targeted at specific taxpayers (i.e. those with undeclared offshore assets), for a defined duration. On the other hand, permanent program is typically created to offer the majority of taxpayers a chance of participation at any time (OECD,

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<sup>15</sup> Park Wonsuk (a member of National Assembly), press release 21 September 2014, <http://www.intn.co.kr/news/articleView.html?idxno=326483>

2015b). Therefore, implementing Offshore Voluntary Disclosure Program as a temporary program is more proper in Korea since it deals with a specific issue: hidden offshore assets and/or income. The current Offshore Voluntary Disclosure Program aims at a specific taxpayer group in order to tackle offshore tax evasion and, thus, appropriate as a special and temporary institution. In addition, the program does not have to be a permanent program because the government will get more detailed and reliable information soon through automatic exchange of information and enhanced cooperation between tax administrations.

## **(2) Evaluation based on the OECD principles**

The suitability of the Offshore Voluntary Disclosure Program in Korea is evaluated by the OECD principles. The OECD made principles for successful voluntary disclosure programs based on the experience of countries. There are six principles: “i) clear about its aims and its terms, ii) deliver demonstrable and cost-effective increases in current revenues, iii) be consistent with the generally applicable compliance and enforcement regime, iv) help to deter non-compliance, v) improve levels of compliance among the population eligible for the program, vi) complement the immediate yield from disclosures with measures that improve compliance in the longer-term” (OECD, 2015b). Although they are not completely appropriate standards for the Korean Offshore Voluntary Disclosure Program, they provide general principles in order to achieve short-term revenue increases and improve

overall compliance in the long-term.

### **1) Clear about its aims and terms**

The current program is aimed at offshore tax evaders. It clearly states that it “enables taxpayers to do normal business activities and fulfill tax obligation by providing them with a temporary opportunity to make things right voluntarily prior to the acquisition of massive amount of financial and tax information through the agreement on automatic exchange of financial account information with other countries” (Ministry of Strategy and Finance, 2015). There are many elements in the program: eligible taxpayers, filing period, the amount of tax and interest, concessions over civil or criminal penalties, and so on. These terms of the program should be definitely set out and accessible to the eligible population and others. Specifically, residents and domestic corporations are eligible. However, if a taxpayer is likely to be imposed tax as a result of tax audit and investigation about income or assets that are to be reported, the taxpayer is ineligible. Filing period is set out. A program participant is waived from penalties and/or fines under the tax laws and the Foreign Exchange Transaction Act. In addition, the program provides lenient treatment on criminal acts as for “tax evasion, foreign exchange transactions reporting non-compliance, and the flight of assets to oversees”, because voluntary disclosure is considered as self-denunciation. They are clearly made public (Ministry of Strategy and Finance, 2015).

The term "resident" means "any individual who has his/her domicile or has his/her place of residence in the Republic of Korea for not less than one year" (The Income Tax Act). However, a taxpayer may have dual residence because each country has different definition of the term "resident". In the case of dual residence, the status of residence is determined by tax treaties. The principles of tax treaties are typically as follows: i) permanent home, ii) center of vital interest, iii) habitual abode, iv) national, and v) mutual agreement. In many cases, the principles are unclear, and the judgements of a taxpayer and the tax authority are inconsistent. There is a need for greater transparency in the principles. However, it is demanding and involves international communities' cooperation. Instead, the government provides prequalification-screening. A taxpayer can apply for it by January 31, 2016, and will be notified of the eligibility within one month from the request date (Ministry of Strategy and Finance, 2015).

The low level of government trust could harm the clearness of the program. The first issue is the confidentiality of the tax information submitted. The government declares that the confidentiality of tax information "will be guaranteed as prescribed in the provision of confidentiality under the Framework Act on National Taxes" (Ministry of Strategy and Finance, 2015). Nevertheless, taxpayers worry disclosure of their information and subsequent tax audits based on the information. Second, taxpayers could be suspicious about the fact that the offshore voluntary disclosure program offers only one-time opportunity. This government trust issue cannot be solved in the near term even though the

program is well designed. Overall, the program is considered as clear about its aims and terms, but the government should understand its weaknesses.

## **2) Demonstrable and cost-effective increases in current revenues**

The short-term revenue increases should be demonstrable, which requires reliable calculation of the revenue gains and the relevant costs; the costs should include the opportunity costs. However, the accurate calculation of the costs is not an easy task, and inherently impossible. Moreover, the Korean government do not make the cost of collection public, and only disclose compliance costs periodically. In 2009, the tax authority announced tax compliance costs for the first time. At that time, the tax authority stated that there were limitations to measure costs accurately and, thus, the government would estimate the costs periodically (3~5 years) and pay attention to the changes in the costs. As well as difficulties in measuring, the publication of the net benefits of the program may be undesirable. Measuring benefits and costs is costly and time-consuming, and incomplete estimates may deteriorate the effect of the program and trust in the government. Therefore, calculation of the revenue gains and costs should be used for evaluating the effectiveness of tax administration in the long-term, not the effect of a specific short-term program such as Offshore Voluntary Disclosure Program. Although measuring demonstrable and cost-effective increase in revenues is virtually impossible, many studies at least agree that offshore voluntary disclosure programs increased short-term revenue.

According to the introduction of the government, the Offshore Voluntary Disclosure Program is to make it possible for taxpayers to do normal business activities and fulfill tax obligation. The program provides them with a temporary opportunity to correct past tax non-compliance voluntarily before the government acquires a lot of financial and tax information through the agreements on automatic exchange of financial account information with other countries. If financial account information of financial institutions would be exchanged with other countries from the year of 2017, offshore income and/or assets would be very likely to be detected. Exchanging countries include the United Kingdom through “the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information” and the United States through “the Korea-US agreement on Automatic Exchange of Financial Account Information” (Ministry of Strategy and Finance, 2015).

If the government obtained financial and tax information and find offshore hidden income and/or assets in the near term, critics may argue that it is not justifiable to give taxpayers an opportunity in order to make things right voluntarily and receive benefits. However, analyzing and investigating the information requires a large amount of administrative costs, and it might not achieve the desired effect, even though the government attains the relevant information. For example, many tax evaders might have tried to hide their identifications, and illegal use of borrowed-name bank accounts is commonplace. Manipulating complex international transactions involving several countries is also possible. They shift profits around the world and

avoid taxes by taking advantage of loopholes in international laws. One of their techniques is moving profits from patent royalties to tax-free countries. Even famous companies like Apple use this kind of technique.<sup>16</sup> In this situation, the government should use the Offshore Voluntary Disclosure Program to encourage taxpayers who are in principle willing to pay the tax to make a disclosure. With relatively small administration costs, the government can achieve the increase in tax revenues and improve tax compliance.

### **3) Consistent with the generally applicable compliance and enforcement regime**

This principle is important, particularly in South Korea. The public awareness exists that the current tax system and tax administration is advantageous to the rich and conglomerates. The Offshore Voluntary Disclosure Program might strengthen this perception and damage overall compliance. Therefore, the program should inspire compliant taxpayers to retain the support and encourage non-compliant taxpayers to improve their compliance. Taxpayers' perception of and response to the program determines the success of the program. The Offshore Voluntary Disclosure Program does not waive unpaid the principle tax due. Instead, a program

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<sup>16</sup> For more information about the technique,  
<http://www.nytimes.com/interactive/2012/04/28/business/Double-Irish-With-A-Dutch-Sandwich.html>

participant is waived from penalties, but not all penalties, excluding additional tax penalties for non-payment or underpayment of tax. In addition, the participant is given lenient treatment on criminal acts, but not given this benefit if the tax due is related to embezzlement or malpractice. The tax authority plans to minimize tax investigation for the program participants. However, it does not prohibit tax audits and investigations to confirm the correctness of filing. The Offshore Voluntary Disclosure Program is consistent with the current enforcement regime in that the process of the program is the same as that of revised return or return after term. Thus, the benefits of the program provide sufficient incentives for tax evaders to come to the open and, at the same time, not reward previous tax evasions. If the tax administration faithfully enforces the principles and exceptions that the program states, the Offshore Voluntary Disclosure Program would not reward previous faults, and would not harm the compliance of most taxpayers who are already compliant.

#### **4) Help to deter non-compliance**

The government clearly declares that “offshore income and assets are very likely going to be detected from the year of 2017 as account information of financial institutions will be exchanged with the countries involved including the United Kingdom through the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information and with the United States through the Korea-US agreement on Automatic Exchange of Financial Account Information” (Ministry of

Strategy and Finance, 2015). Moreover, the tax authority states that the enforcement efforts against offshore tax evasion will be enhanced. The program not only appears attractive to taxpayers, but also gives warning to taxpayers who may seek to manipulate the system by getting the benefits of the program but staying non-compliant. Therefore, the Offshore Voluntary Disclosure Program will deter non-compliance.

#### **5) Improve levels of compliance among the population eligible for the program**

As discussed above, the government declares the higher risk of detection due to expanded exchange of information; as a result, taxpayers eligible for the program but seek to remain non-compliant are more likely to be detected. In addition, the program provides substantial benefits for limited-time period: for example, penalties, fines, and lenient treatment on criminal acts. In addition, the government provides prequalification-screening to make the participation in the program easy. A taxpayer can apply for it and will be notified of the eligibility within one month from the request date (Ministry of Strategy and Finance, 2015). These conditions will look compelling to taxpayers eligible for the program and induce them to participate in the program. Thus, the Offshore Voluntary Disclosure Program will improve compliance for taxpayers eligible for the program.

**6) Complement the immediate yield from disclosures with measures that improve compliance in the longer-term**

The Offshore Voluntary Disclosure Program with enhanced enforcement measures would not damage longer-term compliance. The international tax environment is becoming tougher to non-compliant taxpayers, and the tax authority utilizes the increasing amount of data from automatic exchange of financial account information. The National Tax Service communicates with the public about its enforcement efforts taken against non-compliant taxpayers. The tax authority announces the result of tax audits for offshore tax evasion suspects annually, and the result shows that the amount of levied tax is increasing. Thus, non-compliant taxpayers will feel the detection risk of tax evasion, rather than the benefit of tax evasion, which discourages non-compliance.

The program offers a one-time opportunity. If the benefits are offered repeatedly with no obvious deterrent, taxpayers would take the benefits and remain fundamentally non-compliant, which deteriorates long-term compliance. Therefore, if the government repeats the program, there should be substantial reasons and effective tools to prevent non-compliant taxpayers from abusing the system. For example, the United States and the United Kingdom reversed their positions and repeated voluntary disclosure programs. This decision is justifiable because initial programs made significant achievements and requests for subsequent programs were made from taxpayers, not the government. In the United States, the IRS stated that the subsequent programs were a continuation of the initial program with

modified terms, and the program maintained consistent penalty structures. If the government consider another program, expected reactions of taxpayers should be thoroughly analyzed.

### **(3) Consideration on overall compliance effects**

#### **1) Compliant taxpayers: issue of reverse discrimination**

Evaluation of the Offshore Voluntary Disclosure Program based on the OECD's principles can be categorized into compliance effects on two types of taxpayers: compliant and non-compliant taxpayers. The ultimate goal of the Offshore Voluntary Disclosure Program is to improve overall compliance. The program should maintain the compliance of the vast majority of compliant taxpayers and encourage non-compliant taxpayers to correct their tax affairs. Compliant taxpayers may raise the issue of reverse discrimination. They could argue that giving incentives to non-compliant taxpayers is unfair. Whereas non-compliant taxpayers who have hidden offshore assets may perceive this program an opportunity to report unpaid taxes without heavy penalties, compliant taxpayers might think this opportunity as unfair. It can negatively affect tax compliance of compliant taxpayers. Given that the group of taxpayers is divided into low, middle, and high income groups, the target of the Offshore Voluntary Disclosure Program will be those with high income because they have higher possibilities of having offshore incomes or assets than those with low and

middle income. The implementation of the Offshore Voluntary Disclosure Program could arouse opposition from low and middle income taxpayers. Their tax compliance may be deteriorated, and the equitability of the tax system may worsen.

We need to identify whether the Offshore Voluntary Disclosure Program disadvantages compliant taxpayers and consider how the government can persuade compliant taxpayers and retain the support and compliance of them. First, the Offshore Voluntary Disclosure Program can increase the equitability of the tax system. Equity and fairness is used similarly in the tax administration context. Fairness of taxation refers to the taxation based on taxable capacity. Specifically, taxation should be based on the ability to pay and, thus, collecting less tax from high-income non-compliant taxpayers harms the fairness of taxation. However, we should think about how much fair the current tax system is and whether the Offshore Voluntary Disclosure Program would lower the fairness of taxation from the status quo. Tax authority currently does not know much of offshore tax evasion. Many multinational enterprises and high-income earners pay less tax by depending on offshore tax evasion strategies. In this perspective, it can be said that the current tax system is not fair. If the tax authority could collect more tax by operating the Offshore Voluntary Disclosure Program, the fairness of taxation could increase, although it gives some incentives to tax evaders.

Moreover, the benefits to non-compliant taxpayers who are willing to come forward can be justified based on the fundamental function of

taxation. The objective of taxation is to collect tax revenues efficiently and fairly (Lee, 2014). The core of efficiency is neutrality of taxation, which means that taxation should not affect individuals' behavior in a perfectly competitive market. It is the way to maximize social welfare. In an imperfectly competitive market, however, non-neutrality of taxation can achieve efficiency: for example, there is Pigou tax. This is because non-neutral taxation can move the imperfectly competitive market to a perfectly competitive equilibrium. One of conditions in a perfectly competitive market is perfect information. It means that every participant in an economy have full information, so there is no asymmetry in information. Of course, there does not exist perfect information in real markets. Specifically, the tax authority is not able to find all offshore hidden assets or incomes. In this imperfectly competitive market, the effort of tax authority to obtain more information is desirable. The Offshore Voluntary Disclosure Program causes non-compliant taxpayers to come forward and to reveal offshore information about hidden assets and incomes. Therefore, the program moves the economy to perfect information, which increases the efficiency of the tax system.

However, it is a demanding task to persuade and convince compliant taxpayers. The tax authority needs to consider its communication strategy with compliant taxpayers in order to avoid perceptions of unfairness. The government should be able to show that the government is better dealing with offshore tax evasion and collecting more taxes from high-income earners after the Offshore Voluntary Disclosure Program.

## **2) Non-compliant taxpayers: bringing them to the open system**

We should consider whether this program really can bring non-compliant taxpayers to the open system. Among non-compliant taxpayers, “there are two categories of taxpayers: (i) those who would continue to be unwilling to pay the tax due and (ii) those who would be prepared to pay the tax but had other reasons preventing them from coming forward.” For the first group, the resistance to compliance is affected by particular aspects of the tax laws, such as the rate of income tax. Thus, administrative policies are not likely to affect the compliance behavior of such taxpayers. Taxpayers in the second group, “those in principle willing to pay the tax”, may be receptive to administrative measures. They want to know what results would happen when they comply with the program. To assist taxpayers in the second category, countries should issue clear guidance on process for voluntary disclosure, confidentiality of information disclosed, future compliance activities, no-name discussions, and so on (OECD, 2010).

The Offshore Voluntary Disclosure Program is to offer a bonus for paid taxes, and enhanced enforcement efforts will increase the penalties for tax evasion. Thus, implementing these two strategies together would bring non-compliant taxpayers to the open system. The government’s commitment to stepped-up enforcement should be reliable to taxpayers. Because the amount of tax levied through the investigations toward offshore tax evasion has been increasingly year by year, tax evaders would feel threatened by this trend. In addition, although the effect of new information exchanges on the possibility of detection is still unclear, taxpayers with undisclosed offshore

assets would be worried about it.

On the other hand, non-compliant taxpayers would remain as tax evaders if the government is expected to implement offshore voluntary disclosure program repeatedly. However, even if there is possibility that the government provides the offshore voluntary disclosure program later, taxpayers are not able to anticipate when the next program will happen and, thus, it would be quite risky remaining non-compliant. Therefore, the program is expected to improve tax compliance among non-compliant taxpayers. In contrast, the effect of the Offshore Voluntary Disclosure Program may be restrained by the fact that the government trust in South Korea is not high. Taxpayers with offshore hidden incomes or assets may not believe the government's commitment. If taxpayers anticipate another program in the near future and keep non-compliant, the program would not improve their compliance; the government is not able to discover offshore hidden incomes or assets and increase tax revenue while deteriorating overall tax compliance. Therefore, the program should be designed to minimize the negative effect on tax compliance.

#### **(4) Improvement of relevant institutions**

##### **1) General enforcement efforts**

The Offshore Voluntary Disclosure Program should be a part of a

broader compliance strategy, and relevant institutions should be in congruity with the program. When enforcement regime is reinforced, the Offshore Voluntary Disclosure Program can look attractive to taxpayers. One of hypotheses which is suggested in some previous research is that tax compliance will increase more if offshore voluntary disclosure program occurs with greater enforcement efforts than with no increase of enforcement efforts. If enforcement efforts remain the same after offshore voluntary disclosure program, taxpayers may perceive keeping non-compliant as a better choice. However, if enforcement efforts increase, they will face more audit rates and penalties and perceive this program as a good chance to get back to the normal system. According to a survey, tax compliance perceived by taxpayers, tax practitioners, and government employees is reported to have been increasing in the last 10 years. Regarding the factors of the increase in tax compliance, 46.6% of taxpayers responded that taxation infrastructure, such as the use of credit cards, was the reason. At the same time, 24.4% of taxpayers argued the enforcement of tax audits and penalty tax, and 21.8% of taxpayers argued the increase in tax morale of taxpayers (Kim & Park, 2013). According to this study, enhancement of tax audits can be an effective method to improve tax compliance in South Korea.

In addition, general enforcement efforts can be a more effective tool in reducing tax evasion when taxpayers are aware of the current audit and penalty regime. One study suggests that the tax authority should pre-announce the audit rate and disclose the frequency of audits undertaken in

the previous period. According to laboratory experiments, compliance rate is estimated to be positively correlated with audit probability when the audit information is provided. However, audit probability has no significant effect when the information is not disclosed before the compliance decision. Also, audits have effect on taxpayers who are not actually audited. “The indirect effect of audits, calculated as the taxes collected from those not audited divided by the total audit yield, is 4.4; that is, total taxes collected are 440% greater than the revenues directly collected via the audit process itself.” In addition, the effect of social norms (or social capital) in individual tax compliance decisions is significant. When messages from other taxpayers reveal substantial levels of compliance, compliance rate increases in subsequent rounds (Alm, Jackson, & Mckee, 2009). According to this research, the publication of audit information can positively influence tax compliance. It is desirable that the National Tax Service announces the results for investigations against offshore tax evasion.

## **2) Reinforcement of Foreign Financial Accounts Reporting**

The Offshore Voluntary Disclosure Program is complemented by the Foreign Financial Accounts Reporting. The penalty of the Foreign Financial Accounts Reporting induces taxpayers to reveal their offshore financial accounts and, at the same time, the taxpayers will consider to participate in the Offshore Voluntary Disclosure Program. The Foreign Financial Accounts Reporting is an institution to discourage offshore tax evasion in advance and encourage non-compliant taxpayers come back to

the normal system by imposing penalties. Although it does not directly make taxpayers report hidden offshore incomes and pay the tax, the Foreign Financial Accounts Reporting should be reinforced in order to tackle offshore tax evasion effectively with Offshore Voluntary Disclosure Program.

For taxpayers with a high risk of facing willful violations of the Foreign Financial Accounts Reporting, the Offshore Voluntary Disclosure Program looks attractive. The Foreign Financial Accounts Reporting makes entering the Offshore Voluntary Disclosure Program more convincing and a better choice for taxpayers than it may seem (Mishory, 2013). Therefore, enhancement of penalty for the Foreign Financial Accounts Reporting will raise the incentive for the Offshore Voluntary Disclosure Program. As mentioned above, the number of taxpayers reporting and the amount of reported money have been steadily increasing. If their financial accounts are related to tax evasion or illegal activity, taxpayers would be hesitant to report their financial accounts. However, they still fear the detection by the tax authority, and raised penalty increases the fear. In this situation, non-compliant taxpayers have an incentive to take advantage of the Offshore Voluntary Disclosure Program. They correct previous their tax affairs through the program and report their financial accounts.

### **3) General voluntary disclosure program**

If the amended return is submitted after 6 months or 2 years from

the right timing, the reduction of penalty taxes or criminal punishment is not given. Even after 6 months or 2 years from the right timing, it might be desirable to give the minimal level of reducing penalty taxes if taxpayers amend voluntarily. In Germany, the reduction of penalties and criminal punishment is not given to those whose evaded taxes are over 50,000 euro (Kim, 2015). However, excessively generous structure of the program may harm the support and compliance of the vast majority of compliant taxpayers. An alternative is to give additional incentives only for foreign incomes, or in case of the repatriation of the funds, considering the equity among faithful taxpayers, domestic tax evaders, and offshore tax evaders. For instance, in the Foreign Financial Accounts Reporting, the benefit for voluntary correction was the same as general program at first: when reporting was filed within 2 years, the penalty was reduced by 10% ~ 50%. Since 2015, the benefit has significantly increased; both the eligible term and the rate of reduction increase and, thus, when a taxpayer files a reporting within 4 years, the penalties are reduced by 10% ~ 70%.

#### **4) Trust building in preparation for future programs**

The application of the Offshore Voluntary Disclosure Program was due to March 31, 2016. The government declared that the program offered taxpayers only one-time opportunity. However, it is possible for the government to change its stance, considering the experiences of the United States. In the United States, the first 2009 program was successful. The IRS received 15,000 disclosures prior to the closing date and another 3,000

disclosures after the closing date. As a result, the IRS collected \$3.4 billion tax revenues including taxes, interests, and penalties. After the 2009 program, there were requests from tax practitioners that additional taxpayers wanted to come forward and disclosure their offshore information. The second 2011 OVDI also created 15,000 disclosures and \$1.6 billion tax revenues. And then, the third 2012 OVDP was implemented, and it is made permanent until further notice. Currently, the amended version of 2012 OVDP is continuing.<sup>17</sup>

Reversing a government's decision damages the trust in the government policies. However, if it is backed up by strong support of taxpayers and tax professionals, the damage would be minimal. To repeat the Offshore Voluntary Disclosure Program in the future, the result of the current program should be positive and substantial. When the first program is successful, those who are eligible for the program but do not participate in it would have an incentive to participate in the second program. They will realize that other non-compliant taxpayers came forward to the open system voluntarily and a handful of remaining non-compliant taxpayers will be a target of stepped-up enforcement efforts. They face the increased possibility of detection and a greater cost of tax evasion. Moreover, the success of the first program can persuade compliant taxpayers. If the program succeeds to bring tax evaders to the tax system and collect a lot of taxes from them, the compliant taxpayers would understand the necessity of the program and

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<sup>17</sup> <https://www.irs.gov/uac/newsroom/irs-offshore-voluntary-disclosure-efforts-produce-6-5-billion-45-000-taxpayers-participate>

retain the compliance. The subsequent Offshore Voluntary Disclosure Program should be less generous than the first program. Participants in the first program should receive the greatest benefits. If benefits increase or remain in the future program, it would signal that remaining non-compliant is the best strategy. After all, it deteriorates the trust in the government, and the Offshore Voluntary Disclosure Program fails.

### **5) Simplification of the tax system**

On the economic model of tax evasion, marginal tax rate and compliance costs are benefits of tax evasion. It makes tax evasion unattractive to lower marginal tax rate or reduce compliance costs by simplifying the tax system. However, the tax system is likely to get complicated with time. “Political pressures for policy changes are strongest when the winners from these changes are concentrated and have much to gain and the losers are diffused and don’t lose much per person.” Therefore, many deductions and exemptions that are beneficial to a few wealthy individuals are made, and most taxpayers pay more to cover the loss. Another reason for complicating tax code is the political perception that average voters do not understand identical budget implications of a new government spending program and a tax expenditure. An expenditure program that support the same goal has identical budget implications whether it is financed by government spending or tax expenditure (Gruber, 2013).

This paper does not argue for the flat tax, but the idea of the flat tax is useful in simplifying the tax system. Under the flat tax, all income is categorized into either wages or business income, and they are taxed at the same rate. The base for the wage flat tax includes total wages, salaries, and retirement benefits less a family allowance. The family allowance makes the flat tax system progressive. And the base for the business flat tax is “total revenues from sales of goods and services less purchases of inputs from other firms less wages, salaries, and pensions paid to workers less purchases of plant and equipment.” The first virtue of the flat tax is simplicity. There is consensus on the simplicity of the flat tax. Tax reporting procedures become simple. Hall and Rabushka called it “the postcard tax return” since the tax form is a small postcard size. The simplicity of the flat tax is able to reduce compliance costs which are direct costs of the tax system. In addition, low marginal tax rate increases the economic efficiency. A tax creates a deadweight loss which harms the efficiency of the economy. It is well known that the size of a deadweight loss is proportional to the square of the marginal tax rate. The flat tax achieves a fundamental goal of tax reform that broadens tax base and lowers tax rate. By including all incomes and abolishing deductions, it broadens the tax base and can lower tax rate while maintaining current tax revenues. Low marginal tax rate minimizes the distortion of economic behaviors, which reducing the deadweight loss. Moreover, taxpayers do not have to make unnecessary efforts to reduce their tax burdens because complex deductions and exemptions are removed. Their valuable resources, such time and money, can be invested in productive activities (Hall & Rabushka, 1995).

In the current tax system in Korea, deductions and exemptions are too complicated and redundant, which are criticized for being unfairly advantageous to the rich and big businesses. Some may argue that such tax incentives are necessary for promoting desirable activities, such as R&D and charitable contributions. However, these activities can also be achieved by other tools like government direct expenditures. There is no justification to offer tax incentives. In fact, they are adopted because making tax incentives is politically easier than drawing up additional budgets. Therefore, deductions and exemptions should be repealed gradually. It lowers compliance costs and the incentive of tax evasion. In addition, the level of progressivity and marginal tax rates should be determined by the public's consensus in the democratic society, although the flat tax contends that tax rates and the number of tax brackets should be lowered. Regarding the number of tax brackets, economic disincentives are greater when incomes are adjacent to the boundary of tax brackets; thus, a lot of tax brackets make the economic disincentive prevalent. In South Korea, the number of tax brackets in income tax is five which is not excessive comparing with other countries' tax system and seems not to create substantial distortions. However, increasing marginal tax rates and the number of tax brackets should be restrained because it will complicate the tax system and encourage taxpayers to evade their tax obligations.

## **5. Conclusion**

Voluntary tax reporting and payments account for more than 90% of total tax revenue. The National Tax Service prefers to focus on taxpayers' voluntary cooperation rather than coercive tax investigation. However, the tax authority did not have the tools to attract voluntary cooperation from taxpayers in the domain of offshore tax evasion before the Offshore Voluntary Disclosure Program was initiated on September 2015. Despite the fact that offshore tax evasion shrinks the tax base of a country and damages the equitability of the tax system, the tax authority lacks the capability and information to deal with offshore tax evasion. The government began to toughen enforcement efforts for offshore tax evasion by institutionalizing the Offshore Voluntary Disclosure Program. The ultimate goal of the Offshore Voluntary Disclosure Program is to improve tax compliance for all taxpayers. This paper argues that the Offshore Voluntary Disclosure Program is necessary given the current circumstances in Korea, and that the program's structure is appropriate for the purpose of improving overall tax compliance. Because incomplete data makes calculating tax compliance quantitatively infeasible, the OECD's principles for successful voluntary disclosure programs are used as indirect standards to evaluate the effect on tax compliance. In addition, this paper suggests that relevant institutions should act congruently with the Offshore Voluntary Disclosure Program to maximize the effect on tax compliance.

The Offshore Voluntary Disclosure Program is necessary given the current circumstances in Korea. First, the government needs additional tax revenue. Despite the strong demand for income redistribution and social welfare spending, the government is reluctant to raise tax rates. Therefore, the tax authority should increase tax revenue by catching offshore tax evasion, which is projected to be enormous and a politically-attractive target. By using the Offshore Voluntary Disclosure Program, the government has the opportunity to make a lot of revenue and improve the equitability in the tax system. Second, the Offshore Voluntary Disclosure Program helps the tax authority to deal with offshore tax evasion. Due to lack of information and public power in foreign countries, the government has trouble uncovering offshore tax evasion and collecting money. The Offshore Voluntary Disclosure Program can decrease offshore tax evasion and increase revenue in a cost-effective fashion. Third, the Offshore Voluntary Disclosure Program is appropriate as a temporary program because the tax authority will acquire more financial information through international information exchange. With more information, the government will be able to deal with offshore tax evasion more effectively. Voluntary cooperation from taxpayers is useful only for a short period of time before information exchange starts.

The Offshore Voluntary Disclosure Program has a structure appropriate for the overall improvement of tax compliance. Because measuring tax compliance is incomplete, this paper utilizes the OECD's principles for successful voluntary disclosure programs as subsidiary

standards to evaluate the effect on tax compliance. First, the Offshore Voluntary Disclosure Program is clear about its aims and terms, and clearly states that it gives taxpayers the opportunity to report undisclosed offshore income and/or assets. Elements of the program, such as eligible taxpayers, filing period, the amount of tax and interest, and concessions over civil or criminal penalties, are defined unambiguously. Second, the Offshore Voluntary Disclosure Program can provide demonstrable and cost-effective increases in current revenues. Because the program enables taxpayers to conduct business activities as normal and fulfill tax obligations, revenue increase is predicted to follow its implementation with relatively small administration costs. Many studies about tax amnesty predict that, even at worst, short-term revenue will increase. Third, the Offshore Voluntary Disclosure Program is consistent with the generally applicable compliance and enforcement regime. Although the program gives non-compliant taxpayers some benefits, it does not exempt them from paying their taxes, or from tax investigations. Fourth, the Offshore Voluntary Disclosure Program can help deter non-compliance, and the tax authority is ready to complement the immediate yield from disclosures with measure that improve compliance in the longer-term. The program offers a one-time opportunity. The government has declared clearly that offshore income and assets are likely to be detected from 2017 onwards because of information exchange. Although the tax authority provides tax amnesty, enforcement efforts for offshore tax evasion are toughening with time. Fifth, the Offshore Voluntary Disclosure Program will improve levels of compliance among the population eligible for the program. Prequalification-screening helps

taxpayers who are willing to participate in the program. At the same time, taxpayers eligible for the program but who seek to remain non-compliant face increasing risk of detection.

General enforcement efforts are determinants of the success of the Offshore Voluntary Disclosure Program. Greater enforcement efforts are necessary to induce taxpayers to participate in the program. A well-designed program coupled with an enhanced enforcement regime will give non-compliant taxpayers an incentive to make voluntary corrections, and consequently, compliant taxpayers will be satisfied with the result of the program. First, the rate and intensity of tax audits should increase. The rate of tax audits has not changed as of yet because companies continue to request they not do so on the grounds of economic depression. The tax authority also does not have a strong incentive to oppose them because tax revenue from voluntary reporting and payments accounts for more than 90% of total tax revenues. Even though domestic tax audits do not intensify, tax audits for offshore tax evasion should be tougher. Offshore tax evasion is unrelated to economic recession in the country; instead, it worsens the recession by shifting domestic wealth offshore. Second, the Foreign Financial Accounts Reporting should be reinforced. Taxpayers who do not participate in the Offshore Voluntary Disclosure Program this time are unlikely to participate in the Foreign Financial Accounts Reporting, as the benefits do not outweigh the costs of coming back to the open system for them. However, if penalties for not complying the Foreign Financial Accounts Reporting intensify, they will fear the stepped-up enforcement

regime and look for an opportunity to come forward.

As a final step in the decision-making process for offshore voluntary disclosure programs, the tax authority needs to consider its communication strategy. This communication strategy should contain two main components – communication with target taxpayers in order to attract and encourage them to participate, and communication with compliant taxpayers in order to create an understanding of the program and to avoid perceptions of unfairness that would adversely affect compliance (OECD, 2015b). Despite the fact that the Korean government should have learned from past policy issues which arose from a lack of communication, the tax authority has been uncommunicative with both target taxpayers and compliant taxpayers in the course of implementing the program. Before the implementation of the Offshore Voluntary Disclosure Program, the National Assembly modified the “Adjustment of International Taxes Act” on 23 December 2014. Based on this act, the Minister of Strategy and Finance was given the power to, at the request of the Commissioner of the National Tax Service, execute the Offshore Voluntary Disclosure Program at will. However, the press and the public did not notice this change at that time, partially because the tax authority kept quiet out of concern that they would be criticized for implementing a program which would be seen as being advantageous only for the rich tax evaders. Even after the implementation of the Offshore Voluntary Disclosure Program, the government did not attempt to communicate with taxpayers actively. Because the result of the program has not been made public, it is too early to judge its success or failure. What

is certain, however, is that the government lost the opportunity to communicate with taxpayers and gain the taxpayers' confidence. Although tax evaders generally have a keen interest in tax regulations, it is uncertain how many taxpayers eligible for the program knew about the program and contemplated participating in it. Moreover, compliant taxpayers will not trust the government if they discover in the future that the government carried forward with the program secretly.

No one single program in the entire tax system is essential to improve tax compliance. As a tax system becomes complicated, utilization of loopholes in the tax system and tax evasion increases. Political pressures drive many deductions and exemptions, resulting in a highly complex tax system. Because marginal tax rates and compliance costs are benefits of tax evasion, lowering marginal tax rates and simplifying the tax system makes tax evasion unattractive. By applying a flat tax which levies a low tax rate on a comprehensive definition of income, tax revenue generation could be maintained while simplifying the overall tax system. Lower marginal tax rates do not alter the average person's economic activities, and increase economic efficiency. Moreover, tax reporting procedures will become simple, and people will be able to engage in more productive activities than tax evasion. Tax law in South Korea is experiencing fragmentary amendments to reflect the change of economic circumstances and diverse needs from all levels of society. As a result, the tax system has become so complex that only experts can understand how taxes are calculated. Simplification of the tax system could solve a significant amount of problems including offshore tax evasion.

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## 국문초록

자발적 신고제는 역외탈세 문제를 해결하기 위하여 납세자들로부터 자발적 협력을 이끌어 내는 새로운 접근방법이다. 이 글은 한국의 자발적 신고제가 납세순응도를 제고시킬 수 있을지 분석해보고, 이 제도가 보다 효과적으로 작동하기 위해 필요한 개선사항을 제안하는데 목적이 있다. 증가하는 정부지출과 역외탈세의 심각성은 자발적 신고제의 도입을 필요로 한다. 해외 사례를 검토한 결과, 자발적 신고제의 구조 및 세부내용에 큰 문제가 있다고 보이지 않는다. 자발적 신고제는 납세순응자와 납세비순응자 모두의 납세순응도에 긍정적인 영향을 미칠 수 있는 적절한 유인구조를 가지고 있다. 연구자는 자발적 신고제와 관련 제도들의 정합성이 제도의 성공을 위해 중요함을 강조하고 있다. 세무조사와 해외금융계좌 신고제도를 포함한 집행노력이 점진적으로 강화되어야 한다. 제도를 시행하는 과정에서 납세자들과의 의사소통을 위한 전략도 필요하다고 주장한다. 추가적으로 조세제도를 단순화하는 것이 탈세행위를 줄이는 근본적인 해결방법이 될 수 있음을 제기하고 있다.

**주요어 :** 탈세, 국제조세, 자발적 신고제, 조세사면, 납세순응

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