



The introduction of an appeals court in Dutch tax litigation

Jurjen J.A. Kamphorst^{a,*}, Ben C.J. van Velthoven^b

^a Utrecht School of Economics, Janskerkhof 12, 3512 BL Utrecht, The Netherlands

^b Faculty of Law, Leiden University, PO Box 9520, 2300 RA Leiden, The Netherlands

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ABSTRACT

As of January 1, 2005, a court of appeal has been introduced in Dutch tax litigation. Before that date, the substantive merits of a tax dispute could only be heard in one instance. In this paper we investigate which consequences the introduction of the appeals court may have for the way tax payers and the tax administration solve their disputes. We focus on the following questions. Are more or less tax payers willing to go to court to solve the dispute? Is it more or less difficult for parties to agree upon a settlement? Which appeal rate can we expect? What is the role of society's confidence in the courts in the answers to the questions above?

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1. Introduction

In the Netherlands, a tax payer who wants to dispute his tax assessment first has to file a notice of objection at the tax administration itself. If at the end of that procedure he still disagrees with the final assessment, he may go to court. Before January 1, 2005 the tax payer had to bring his case to the tax section of the Court of Appeal ('Gerechtshof'). In the Netherlands, this was the only instance which considered the substantive merits of the case. Neither side could appeal the judgment of the court on the grounds that the court misjudged the facts. Since January 1, 2005, things have changed. Tax disputes are first brought to a District Court ('Rechtbank'). After its verdict, both parties have the option to appeal on substantive arguments. The 'Gerechtshof' now hears tax cases in second instance.

The goal of this paper is to gain insight in to the consequences of the introduction of an appeals court for the choices made by the tax payer and the tax administration in solving the dispute. Of course, the possibility to appeal increases the number of options open to the players. The option to appeal can be an advantage, when the first trial is lost. But it can also be a disadvantage, when the first trial is won but the other party does not give up. Moreover, when players go to court for the second time, they face additional costs.

We are especially interested in the following questions:

1. Are tax payers more or less willing to go to court over the dispute?
2. Are players more or less likely to settle their dispute?
3. To what degree will players appeal the decision of the court of first instance?
4. How does society's confidence in the courts affect the answers to the questions above?

There seems to be no economic literature in which the decision to go to court in the first instance is modeled together with the possibility to appeal. The papers which study the appeals process focus on the internal organization and dynamics of the judicial system, not on the choices by the parties in the dispute. For example, [Shavell \(1995\)](#) investigates how the judiciary should be arranged in order to minimize the combined costs of a mistake in the last verdict and the legal costs to all parties. He finds that a court of second instance can be beneficial, if (i) the court of second instance gets relatively more means so that it is more reliable than the court of first instance, (ii) parties get the option to appeal or not, and (iii) the proper (dis)incentives to appeal, via court fees or subsidies, are in place. [Spitzer and Talley \(2000\)](#) analyze the policy choices that the higher court could make in reviewing verdicts of lower courts when lower courts may not only make mistakes, but may also have an ideological bias. [Daughety and Reinganum \(1999, 2000\)](#) analyze how later verdicts in a case are affected if the information contained in the earlier verdicts and the decisions to appeal are taken into account.

In this paper we look at the connection of the courts in the first and second instance from the other side, namely from the perspective of the parties in the dispute. How is the decision to go

* Corresponding author.

E-mail address: j.kamphorst@econ.uu.nl (J.J.A. Kamphorst).

to a court of first instance affected if players may appeal its verdict? The paper is organized as follows. In Section 2 we introduce the general set-up of the model. Section 3 briefly discusses the old situation in which no appeal was possible. Sections 4 and 5 analyze how the new situation differs from the old one. We will see how the outcomes are affected if players learn about their chances in the court of second instance from the verdict in first instance. We also discuss the role of society's confidence in the courts. Section 6 summarizes the results and draws attention to some relevant aspects that have yet to be built into the model.

2. The set-up of the model

There are two players, the tax payer P and the tax administration A . Both players are assumed to be risk neutral and there is common knowledge on the game and the beliefs of the players. Before, P received a tax assessment from A . Disagreeing with the assessment of A , P submitted a notice of objection. At the end of that procedure, however, P still feels that the final assessment is too high, say by an amount Y . Hence there remains a conflict between A and P . Now each player chooses their strategy to resolve this dispute. The options to the players are given in the game tree of Fig. 1.

We distinguish two stages in the game, indicated by subscript g . Stage 1 refers to the choices and decisions in first instance. Stage 2, which starts after the verdict of the court of first instance, consists of two subgames: Stage 2P if player P won the first trial, and Stage 2A if player A won the first trial. Notice that Stage 1 taken by itself reflects the old situation, while Stage 2 reflects the additional options after the introduction of the appeals court.

In each part of the model players first have the option to settle (S) or not settle (NS). If the players settle, they agree on the amount (denoted by SA_g) which P should pay to A . After that the game ends. If not, the player who is put in the unfavorable position as a result of the current decision (the unsatisfied player)¹, say player i , may go to court (C) or give up (G). If i gives up, the game ends and the current decision is implemented. If i does go to court, he pays court fee f_g^i , and each player j pays his legal costs c_g^j . If player i wins that trial, his court fee for the trial is refunded.² If the last trial before the game ends is won by player P , then A is ordered for costs, that is, A has to refund part³ of the legal costs of P . This refund equals q_1 if the players went to the court of first instance only, and it equals $q_1 + q_2$ if the players went to the appeals court too. Further, let p_g^i be the probability estimate by player i of winning the trial in Stage g , and $E^i(\pi_g^i)$ his expected payoff of that trial.

We assume that there is no breakdown in bargaining if the bargaining set is non-empty. Provided that the unsatisfied player has a credible threat of going to court and that there exists some settlement amount which both players prefer to another trial, then such a settlement will be reached. As such, we can model the decision of accepting the settlement or not as the decision of the satisfied player only. Specifically, in our numerical analysis we assume that the settlement amount lies halfway between the lower and upper bound of the bargaining set.

¹ So player P in Stages 1 and 2A, and player A in Stage 2P.

² Court fees are paid to and refunded by the court's registry, which – as a matter of fact – is part of national government organization just like the tax administration. In terms of budget and administration, however, the tax administration and the justice department are very much separate and independently operating units. So we have chosen not to consolidate these units in the set-up of our model.

³ In the Netherlands, refunds of legal costs are based on a point system. Generally the amount refunded is (substantially) less than the actual legal costs incurred. Moreover, although it is in principle possible that tax payers are ordered to refund the legal costs made by the tax administration, this only rarely happens.

3. The old situation: no appeal

The model for the old situation which existed until January 1, 2005 is just an application of the well-known divergent expectations model from the literature. See for example Shavell (1982). Therefore we will discuss it only briefly.

Note first that the expected pay-offs from a trial are given by

$$E^P(\pi_1^P) = p_1^P(-c_1^P + q_1) + (1 - p_1^P)(-f_1^P - c_1^P - Y), \quad (1)$$

$$E^A(\pi_1^A) = p_1^A(-c_1^A + Y) + (1 - p_1^A)(-c_1^A - q_1). \quad (2)$$

In any subgame perfect equilibrium, P will give up if a trial would cost him more than paying the disputed amount Y . From (1) it follows that P will play strategy G if and only if

$$p_1^P \leq \frac{(f_1^P + c_1^P)}{(f_1^P + q_1 + Y)}. \quad (3)$$

So P will accept the final assessment of A , unless P has sufficient faith in his chances to win the trial (i.e. if p_1^P is high enough). Note that P will not have a credible threat, regardless of his estimated chances in court, if $q_1 + Y < c_1^P$, that is: if the refund of legal costs does not cover the real legal costs, and Y is small enough.

Obviously, A will not agree to settle if P is not willing to go to court. However, if P is willing to go to court, a settlement may still be impossible. The minimum A demands equals his expected benefit of going to court $E^A(\pi_1^A)$, while the maximum P is willing to pay is equal to his expected loss of going to court, namely $-E^P(\pi_1^P)$. Hence, a settlement is possible only if

$$p_1^A(-c_1^A + Y) + (1 - p_1^A)(-c_1^A - q_1) \leq p_1^P(c_1^P - q_1) + (1 - p_1^P)(f_1^P + c_1^P + Y). \quad (4)$$

Rearranging Condition (4) yields

$$(p_1^P + p_1^A - 1)(q_1 + Y) \leq c_1^P + c_1^A + (1 - p_1^P)f_1^P. \quad (5)$$

The right-hand side (RHS) equals the costs which parties can save by not going to trial. The left-hand side (LHS) equals the amount by which their joint claim exceeds the amount to be divided ($q_1 + Y$). Thus if the LHS is not larger than the RHS, then the costs of going to court outweigh the sum of the perceived benefits and players will choose to settle. This is always true if $p_1^P + p_1^A \leq 1$. However, if players are *jointly optimistic*, defined as $p_1^P + p_1^A > 1$, then it can occur that their joint claim exceeds the costs of trial. In that case, players will go to court.

Conditions (3) and (5) are graphically represented in Fig. 2. The figure shows how, given some set of parameters, the subgame perfect strategies depend on the beliefs of the players. For each point in area G, P will give up. For each point in area S the players will settle, and for the points in area C the players will go to court.

From Condition (3) it is clear that the borderline between G and S lies more to the right the lower are q_1 and Y , and the higher f_1^P and c_1^P . Condition (5) shows that the borderline between S and C shifts to the right if q_1 or Y decreases (because the amount to be divided becomes lower), or if c_1^P , c_1^A or f_1^P increases (because the total costs of trial become higher).

Summarizing, the conclusions for the old situation are the following:

1. When the refund of legal costs is incomplete, player P has no credible threat if the disputed amount Y is sufficiently small. Such small disputes will never go to court.
2. Parties will only go to court if they are jointly optimistic, so if $p_1^P + p_1^A > 1$.
3. The probability of a trial increases in:

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