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**THE TAX ADMINISTRATION'S EXAMINATION FUNCTION
AND CONTROL OF EVASION**

Topic 2.3

**INFORMATION SYSTEMS FOR SUPPORTING
EXAMINATION**

Flemming Paludan

Central Customs and Tax Administration

Denmark

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Case Study

TOPIC 2.3 THE DANISH SYSTEM FOR THE ASSESSMENT AND AUDITING OF INCOME TAX RETURNS

Flemming Paludan

Deputy Director Taxpayer Services
Central Customs and Tax Administration
(Denmark)

CONTENT: Overview.- Historical Background.- Reporting to the Inland Revenue Authorities.- Selection of Taxpayers in the SLS-P.- Future Development Trends in the SLS-P.- The Use of Centralised Selection Systems vs the Use of a Data Warehouse.- Future Trends.- Computer-based Selective Searches for Businessmen in Connection with the Assessment.- Time Schedules.

OVERVIEW

The Danish Income Tax system is based on the annual filing of individual income tax returns.

Personal income tax is levied through a unitary system in which the State and the municipalities cooperate. The Central Customs and Tax Administration has the overall responsibility for tax collection, whereas 275 local municipalities undertake tax assessment, auditing and taxpayer assistance.

The National Tax Board makes yearly plans and sets targets for the tax assessment and auditing to be carried out by the municipalities.

The Central Customs and Tax Administration supervises and supports the municipalities to ensure that the assessment is performed in the same manner nationwide, and that the targets are specified by the National Tax Board.

To assist the local authorities in carrying out their task, the Central Customs and Tax Administration has developed a comprehensive computer system to check and audit Income Tax Returns. The computer system is called 'Statens Ligningssystem for Personer' - the SLS-P (the Government Assessment Computer System for Personal Income Tax).

The information available in the SLS-P is obligatory information submitted to the Central Customs and Tax Administration in accordance with the provisions of the Danish tax

laws. This may be information from employers on the payment of income and on withheld taxes and payments to pension schemes. The banking institutions report payments of interest and capital (unearned) income. In addition there is information available in the system that is useful to the local assessment authorities, such as change of civil status, population data, registration of ownership of land and buildings, and registration of vehicles.

The system presents the information in a way suitable for the carrying-out of the assessment.

The system is mainly used to assess the income of individuals not engaged in business.

Recent years have seen the start of the use of a data warehouse by way of supplement to and maintenance of the SLS-P system, and a recently launched initiative to modernise the income tax return system for businesspersons will make it possible, within few years, to develop a computer-based assessment facility for this group of citizens as well.

HISTORICAL BACKGROUND

Denmark is a kingdom with 5,300,000 inhabitants in the northern part of Europe. The Danish gross domestic product is worth DKK 1,216,000,000,000 (1999) and the average yearly income is DKK 166,000 (i.e., about USD 23,000). Denmark is a democratic constitutional society with a very low crime rate and without any sort of corruption.

In 1970, Denmark introduced taxation at the source (PAYE tax) where the ongoing payment of tax is made on the basis of a provisional statement of anticipated income – and an income tax return stating the actual income situation after the expiry of the year of taxation.

A few years later, the top-level tax authorities began to link together and create a system for some of the details available, including in particular reports from employers about salaries & wages, etc. The information was compiled for each taxpayer and a paper version sent to the municipality where the taxpayer had his/her residence and was to be assessed.

In connection with the transition to the use of computer registers for income tax return figures it became possible to process the available details before printing-out the paper-based control documents. That became the start of the development of a priority system that would automatically compare the converted income tax return with the information stored in the registers - mainly last year's income tax return and provisional tax assessment details.

From this system a priority form was printed out where the differences or other

circumstances indicated a more detailed investigation.

Later on, there was a further combination of the control systems, and the objective was to compile all the information that was relevant to the assessment of the individual taxpayer - and to print out this information on one form.

The control information was divided into main groups with the following headings:

- salary/wage reporting details
- information about paid taxes
- real property information
- taxable benefits (daily [unemployment] benefits, etc.)
- deductible benefits (child maintenance payments, etc.)
- various details of inheritance, gifts, etc.

These selective searches were used with great success and resulted in significant extra tax receipts. The success brought about an amendment to the legislation that calls for reporting to the Inland Revenue authorities - so that it also became mandatory for banks and savings banks, etc., to file reports about interest on contributions and deposits as well as interest on bonds.

REPORTING TO THE INLAND REVENUE AUTHORITIES

Danish enterprises have a number of obligations to file information as well as to manage a number of cash flows from the enterprises and their employees to the public authorities.

On an annual basis the Central Customs and Tax Administration receives about 12,000,000 reports from employers in Denmark with specified information (up to about 35 sub-criteria) about salary/wage-earners' income situation, as well as almost 50,000,000 interest reports, etc., mainly from the financial sector. The number of salary/wage-earners is about 3,500,000.

The data are subsequently used for control purposes - but they are also used for the purpose of facilitating the work of filing income tax returns for Denmark's taxpayers.

Such reported information as is immediately relevant to the annual income tax return from taxpayers will be transferred to a preprinted income tax return ("print tax return") for some 3,900,000 taxpayers, and to a service letter to the about 600,000 taxpayers whose tax matters are more complicated and who therefore use an extended income tax return.

A preprinted income tax return implies that the income tax return form distributed has been partially completed by the Inland Revenue authorities with the details already reported by employers and financial institutions.

The quality of the data is so high that there is little need for the taxpayer with a print tax return to alter the information reported and transferred to the income tax return system.

The taxpayer will send back the preprinted income tax return to the Inland Revenue authorities - if he has any corrections/additions. Any corrections or additions as well as approval can also be transmitted via the Internet or by means of an ordinary telephone connection.

The municipal tax authorities in connection with their assessment and control of the taxpayers use the information reported to the Central Customs and Tax Administration. In the case of the group of salary/wage-earners the assessment rests largely on these reports from third parties with normally quite different interests, and the subsequent control is based - to a high degree - on selective computer searches in accordance with predetermined criteria.

The information filed by employers consists of all sorts of remuneration - that is, beside the salary or wages, fees, etc., also the most essential forms of fringe benefits such as free (company) car, free lodging, benefits in kind, share options, etc.

Today, reports are made only once per year. As from 2002 a new computer-based solution will be introduced at the Central Customs and Tax Administration which will also enable employers to report - in connection with the monthly disbursement of pay and the contribution to the inland revenue authorities - the amount of the pay and the ancillaries thereto, and the number of working hours, etc., in the month under review. Employers who register for this scheme will then have completed their reporting to the inland revenue authorities altogether for the past period, and for them there will be no need to compile old information and send it to the tax authorities at the end of the year of taxation.

It is anticipated that the new scheme will make things a lot easier for the employers, and that it will soon cover the major part of employers and salary/wage-earners.

The new monthly reporting from the employers will make it possible to carry out ongoing checks on, i.e., employers who might withhold a greater amount of PAYE tax from their employees than what is paid-in to the Inland Revenue authorities. Thus, errors and omissions can be discovered at the exact time when the errors, etc., are made - rather than during the subsequent year when the checking of the reported information is carried out today.

SELECTION OF TAXPAYERS IN THE SLS-P

The system for selecting information is set up around a number of criteria that each local tax administration can select. The system has about 300 different selection criteria. The various selective search criteria are modified and maintained on an ongoing basis so that they are completely relevant in relation to any changes in the tax laws - and,

thus, to enable a fully up-to-date control of income and deductions.

The SLS-P system is used, primarily, for the carrying-out of the municipal assessment work in respect of persons.

The system is arranged so as to incorporate two principal functions:

- Selective search for persons who are suitable for assessment, i.e. persons where the information available signifies a certain presumption that it is a case of non-reporting of income, misunderstandings regarding the use of tax regulations, etc.
- The access to comparison and presentation of control information either in the form of paper diagrams or, today, gradually in most cases on a computer display.

The selection of taxpayers can be grouped as follows:

- Selection of taxpayers with different types and amount of income, salary/wage-earners, capital-income earners, etc.
- Selection of taxpayers with different types and amount of deductions: paid interest, commuting and traveling expenses, maintenance payments, and other deductions permitted according to the Danish tax laws.
- Any notification and selection of taxpayers based on changes in previous years' income/ deduction patterns.
- Selection of taxpayers where there is a mismatch between information reported by the taxpayers and the obligatory information received from other sources.
- Notification and selection of taxpayers based on specific groups of taxpayers. The National Tax Board may decide that certain groups of taxpayers with certain characteristics should all have their income tax returns selected for control purposes in a certain year.
- Notification and selection of certain groups of taxpayers based on criteria selected by the local municipality. The selection is tailor-made to suit the needs of an individual local municipality.

The system ensures that the assessment is carried out in a cost-effective way and assists the local municipalities in selecting only those income tax returns that need to be looked into. At the same time the system provides the background for a continued high rate of compliance.

Via the SLS-P system all tax authorities have access to control information. The control information includes such information as the legislation requires to be reported to the Central Customs and Tax Administration, and a number of details reported by the local councils or other authorities - because it is appropriate that all information relevant to the assessment should be gathered in one place.

In the SLS-P system the information is structured and presented in a manner appropriate to the assessment.

The local councils have access to the information by means of a nationwide computer system, but also via paper printouts if so desired.

FUTURE DEVELOPMENT TRENDS IN THE SLS-P

The assessment of salary/wage-earners has undergone notable changes over the past few years. The number of control details has been increased considerably. The preprinted income tax return generates a proposed income statement, which requires few or no changes or additions on the income tax return for the major part of the non-commercial taxpayers.

Today, a substantial part of the checking of salary/wage-earners' income tax returns is in the form of a testing of the taxpayers' amendments to the preprinted amounts on the income tax returns.

This trend has been so favourable that it is no longer necessary to set up specific requirements for the local tax administrations' carrying-out of the assessment of salary/wage-earners.

Developments have not called for any significant changes to the design of the SLS-P system. The SLS-P is arranged around the same functions as before. The SLS-P was developed during a period of time when the assessment of salary/wage-earners had high priority and gave rise to substantial income increases with resulting, large derived tax receipts.

The SLS-P therefore no longer has the same need for selective search in respect of salary/wage-earners - except where the taxpayer has made changes in the information available to the tax authorities.

It has therefore been deemed appropriate to apply the control - more so than previously - to the quality of the reported information. If this information is largely correct, there will be very limited opportunities to find errors and, therefore, derived tax receipts by checking the salary/wage-earner's own situation.

In its present form the SLS-P system consists of obligatory as well as optional system parts.

The optional system parts, which the local councils have desired to be introduced, have so far been incorporated without any detailed cost-benefit evaluation such as, for example, on the basis of:

- possible increase potential;
- the number of municipalities that wish to use the relevant part;
- how much the municipal administration will be facilitated; and
- how great the development costs, operating costs, etc., will be.

So far the consequence has been that the SLS-P has tended to include a number of criteria that are used by only a very small number of municipalities.

The development in the assessment of salary/wage-earners, etc., as well as the need to apply the development resources where the benefit is greatest, make it necessary to develop the SLS-P system henceforth in accordance with somewhat different principles.

This can be done by ensuring that future developments are effected with due regard to the following factors:

- The National Tax Board's decision to waive special requirements on the local councils as control instrument for the assessment of salary/wage-earners has entailed that there is still a need for a certain measure of control via obligatory selective search criteria and criteria that vary from one year to the next. This ensures that the taxpayers will continue to experience a real risk of control, and that uniformity is created amongst the municipalities.
- An ongoing, critical evaluation of the system is carried out with a view to abolishing components and selective search criteria that are no longer needed - because they bring about no significant assessment result.
- No introduction of new criteria unless a nationwide investigation of specific matters is desired. In these situations the system may be expanded to permit a control of the desired aspect over a predetermined period where it is deemed necessary.
- New criteria are not introduced until the use of data warehouse analyses has revealed a real assessment potential.
- The propriety of using a large, centrally controlled assessment selection system like the SLS-P is evaluated continuously as against other selective search methods.

THE USE OF CENTRALISED SELECTION SYSTEMS VS THE USE OF A DATA WAREHOUSE

It is evident that the strength of the SLS-P system is in the processing of large data

quantities where, nationwide, fixed criteria can select aspects that may call for a more detailed investigation in terms of assessment.

By contrast, it is not possible - or at least very costly - to use the SLS-P system for more individual selective searches where the possibility of adapting the selection criteria to the specific case has a pronounced bearing on the outcome of the selection.

For that purpose the Central Customs and Tax Administration has developed its own data warehouse, which operates on the basis of copies of a large number of centralised registers of VAT and tax matters, including information about interest, salaries/wages and withheld taxes.

This data warehouse makes it possible to draw specific details from the individual register or to compare single pieces of information from several registers and process them in the light of individual and variable parameters. The use of this data warehouse can also be applied - much more so than the SLS-P system - to the processing of information about commercial taxpayers.

In the Central Customs and Tax Administration the data warehouse is used for the solution of acute needs for analyses from the Government and the Danish Parliament and for the planning of the control and assessment work - including the evaluation of new fixed selection criteria in the SLS-P, cf. above.

Besides, the data warehouse fulfils a particular need in connection with the control work in 30 decentralised customs and tax authorities and, to an increasing extent, in the municipalities. In the field of taxation the flexibility of the data warehouse implies that selective searches can be more accurately targeted on specific risk areas - in that the selection criteria can be adapted to, i.e., the local assessment basis, trade conditions or specific tax regulations.

Thus, a nationwide selective search based on average conditions in a largely industrialised community will not necessarily have the desired effect in individual municipalities where income is mainly derived from, for example, farming.

Example:

As an administrative simplification, employers in Denmark may under certain circumstances reimburse their employees' mileage expenses tax-free on the basis of a fixed rate per kilometre.

When implementing a control of this arrangement so as to prevent abuse the problem associated with achieving the optimum selection result will be that a fixed selective search criterion on, for example, the relationship between the firm's payroll expenditure and the tax-free compensations disbursed will treat all trade sectors in the same manner. Instead, the selection must be adapted to the conditions in each trade sector - because, obviously, a sales organisation where the employees drive their own

motorcars in a large geographical area will have proportionately greater disbursements than a firm engaged strictly in production.

FUTURE TRENDS

As already mentioned, now that the reporting of information to the inland revenue authorities has reached its present level, and with the high quality of the information provided, a subsequent assessment control of income tax returns for salary/wage-earners and other citizens with simple income and deduction aspects has become less essential.

Therefore, it seems that the assessment effort could be focused, to a higher degree, on independent businessmen.

COMPUTER-BASED SELECTIVE SEARCHES FOR BUSINESSMEN IN CONNECTION WITH THE ASSESSMENT

As already mentioned, the income tax returns have so far consisted of two different paper versions for salary/wage-earners and other citizens with simple income and deduction aspects, on the one hand, and a more elaborate income tax return form for businessmen and others with more complicated income and deduction aspects, on the other.

As also previously described, due to the nature of the reporting the automatic selections have been focused mainly on the assessment of salary/wage-earners.

The assessment of businessmen has been embraced by the selective search systems only to the extent that reporting has been made (earned income, interest, etc.). The most important part of the assessment has been in the form of a manual scrutiny of the income tax return, financial statements, and other details and documents filed with the income tax return. It is true that reporting is also made to the Central Customs and Tax Administration of details about trade matters, but only companies having an annual turnover in excess of DKK 500,000 (i.e., about USD 60,000) are obliged to perform this reporting.

However, a recently completed fact-finding report on a modernisation of the income tax return situation for businessmen and others with more complicated income and deduction aspects now holds out promises of a substantial expansion of the automatic registration of income, deductions and accounting matters for businessmen, etc.

It has been decided that, over the next two or three years, a new income tax return model will be introduced where the extended income tax return is presented to the businessman on the Internet - completed in advance with such details as are known to the inland revenue authorities. The taxpayer may then accept, modify, or add information to, the income tax return.

This corresponds closely to the model already facing the ordinary taxpayer on the Internet.

However, the model is also being augmented by an accounting module and with the option of including a capital statement.

The taxpayer will be given access to specifications of the preprinted details by "clicking" in them.

Thus, if the taxpayer "clicks" on the already completed box for interest receivable, he can produce a display with a specification of the composition of the interest amount. He will see:

- the registration number;
- the filer's name (bank, etc.);
- the account number;
- the balance; and
- the interest received.

By "clicking" once more he will also be able to find guidance on the field in question.

In addition to the general, more overall guidelines, the businessman must be shown - via links from each box - the relevant, detailed guidance.

The Internet income tax return is tailored to the individual taxpayer. This is done by combining the boxes that the taxpayer is likely to have to use - rather than the taxpayer having to find these amongst a lot of other boxes.

The guidelines will include a "search-and-find" facility so that the entry key to the guidelines will be a term. Thus, the taxpayer may enter "interest receivable", and he will then be guided through a dialogue containing proposals for filling-in the boxes on the income tax return:

- interest receivable on bank deposits, etc.;
- interest receivable on bonds and debentures;
- interest receivable on deposited mortgage deeds;
- interest receivable on non-deposited mortgage deeds; and
- interest receivable from business,

and can thus develop his own income tax return - step by step.

The Internet model must also include facilities for tax calculation, including calculation of the implications for the payment of tax on various possible transactions in the business.

Using the Internet, all details of income and deductions can be displayed with the

information most recently reported to the Central Customs and Tax Administration, which is a further advantage for all parties.

The proposed Internet model implies that taxpaying businessmen are encouraged to submit accounts, capital statements and vouchers, if any, via the Internet or XML (i.e., file transfers). This initiative will also facilitate the administration for businessmen.

Avoiding paper altogether would be an ideal solution. For example, the taxpayers could register for the Internet arrangement, and the Central Customs and Tax Administration would then send an e-mail to the taxpayer when the income tax return is ready on the Internet.

This would call for a registration of e-mail addresses and a demanding administration in the event of changes of address, etc. A practical solution to the many changes of address might be to allocate to each businessman a particular "domain" with the Central Customs and Tax Administration - an official letterbox where the taxpayer can collect his e-mail.

But, for the time being it remains necessary to send out paper-based income tax returns to all taxpayers - although it is realised that this is a sort of double administration.

During a transitional period all businessmen will thus continue to receive the traditional papers without any changes, but a solution is offered where all communication can occur via the Internet.

Via the Internet it must be possible to:

- view and use the reported information to complete the income tax return form;
- file accounts (financial statements);
- file an income tax return;
- submit a capital statement;
- submit various supplementary forms;
- access various guides; and to
- access tax calculation systems.

The scheme is operated by means of a Self-Key code authorising the taxpayer to submit and access the personal details via the Internet.

The taxpayer may file income tax details via the Internet in, for example, the following sequence:

1. First the annual accounts are entered. The Central Customs and Tax Administration is developing an application for data capture of Web-accounts that will replace the filing of paper-based accounts. A few of the figures in the accounts are transferred automatically to the income tax return.

2. The income tax return form is already completed with the details that are available to the tax authorities. "Clicking" on each piece of information produces an interactive box with specifications that the taxpayer may accept, correct, or add to.
3. When the taxpayer has filled in the extended income tax return and approved it, he is taken to a screen showing the capital statement, which is already completed with information from the income tax return plus other amounts - such as taxes paid - that are known to the Inland Revenue service. If desired, the taxpayer may "click" to see further specifications, whereupon the taxpayer accepts, corrects, or adds new information.
4. Finally, the taxpayer approves the income tax return in its entirety for electronic submission.
5. The taxpayer has the option of retrieving his data entry and asking for a tax calculation.

Beside the administrative benefit of being able to receive and process information via the Internet, this system permits a measure of control, which has been available for salary/wage-earners for a long time.

This will be the first time when specified accounting records are registered for all businesses in the country.

An accounts database will be established showing the accounting records for all enterprises. Today, there is a computerised registration of certain accounting records only for those major firms which have so far been obliged - as already mentioned - to submit a specified form with the firm's key ratios.

Accounting data from the existing specified forms for major businesses are included in the governmental and a number of municipal assessment systems, and a development with data for all businesses will imply that all businessmen's income tax returns can be subjected to an unbiased and uniform evaluation and selection.

The selective searches that can be performed belong to two principal groups:

- Assessment Selection
- Audit Selection

The purpose of *Assessment Selection* is to search for tax transactions that were made erroneously. If an item in the accounts shows remarkable fluctuations from one taxation year to the next, this will be selected, too.

In respect of administrative procedures the selective search system will be designed so

that it is possible, in the individual criteria, to insert specific limits in terms of amounts and percentages; these will be selected by the relevant municipality's assessment board. If no selection of amount and percentage limits is made by a municipality, the selective search is made in accordance with a standard.

The purpose of *Audit Selection* is to find indications to suspect that there are errors in a businessman's basic registration of cash flows. Another purpose is to carry out a weighting amongst the selected accounts - based on a number of cost-benefit considerations.

A further objective is to make the various calculations of key ratios and trade comparisons available to the municipal assessment authorities with a view to the carrying-out of local selective searches.

TIME SCHEDULES

The first part of the outlined income tax return arrangements has just been implemented for the 2000 year of taxation, in that access has been provided for computer-based interaction on the Internet between the Inland Revenue service and the business world. Later on, in 2002, the scheme with flexible standard accounts and automatic printout of the annual tax settlement and money transfers will follow.

Flemming Paludan
Deputy Director General
Central Customs and Tax Administration,
Ministry of Taxation
Oestbanegade 123, DK-2100
Copenhagen, Denmark
E-mail: flp@tu22.ccta.dk