Inter-American Center of Tax Administrations – CIAT
Internal Revenue Service of Chile

35th CIAT GENERAL ASSEMBLY

THE TAX ADMINISTRATION'S EXAMINATION FUNCTION AND CONTROL OF EVASION

Santiago de Chile, Chile
April 2-5, 2001

The stability of management[10] and the persistence of a clear and defined leadership for over ten years have been key factors in getting the necessary political and administrative support, enabling the SII to achieve the accomplishments it did in the 1990s.

b) Professionalization and Betterment of the Level of Officials

Meeting the objective of increasing collections while maintaining the SII powers and normal level of resources required the commitment and dedication of all SII officials, so as to improve their productivity and collaborate in meeting the collection goals. To that end, the SII concerned itself with establishing a civil service career which, through clear rules and requirements for hiring, promotions and appointments, would satisfy the different demands of new slots or openings through internal contests (background, tests, etc.).

At the same time, the low level of remuneration of SII officials was increased. In the 1990s, real remuneration levels for the different SII echelons increased (discounting inflation) by 136% on average. With this, the income of those officials was brought in line with the market levels, with the exception of the remuneration for high-ranking officials. Despite the salary hike, the remuneration of top officials remained below the remuneration level for similar positions in the job market.

In the same manner, *training* became a necessary and important activity for all officials and directors. To that end, it became necessary to invest resources in preparing courses and teaching materials, gaining access to new methodologies (self-instruction, correspondence education, etc.). From the standpoint of contents, training was geared toward improving the professional and technical level of officials but also improving such skills as dealing with the public, working as a team, etc. One of the most important aspects was the all-out effort to work on value issues, in particular official's integrity, at all SII levels.

[10] *Javier Etcheberry was named SII Director in 1990 by President Patricio Aylwin A. He was ratified in his post by Aylwin's successors, Presidents Eduardo Frei R-T and Ricardo Lagos E.*

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Welcome Statement by Mr. Javier Etcheberry Celhay,
Director, Internal Revenue Service of Chile

FRIENDS OF CIAT:

Javier Etcheberry

The representatives attending the General Assembly held last year in Washington, D.C., United States, entrusted the Internal Revenue Service of Chile the organization of the 35th CIAT General Assembly. Having accepted this distinguished commitment, we shall be holding this Meeting in Santiago on April 2-5, of this year.

The CIAT General Assemblies are an international forum of the highest level for the exchange of experiences and in-depth consideration of urgent problems continuously faced by our Tax Administrations in their various functional areas.

The main theme of the meeting of Santiago de Chile will be “The Tax Administration’s Examination Function and Control of Evasion”. Accordingly, on this occasion we must analyze that complex dichotomy which shall always be an unavoidable challenge for the tax administrators. On the one hand, “the function of examination” of the correct and timely compliance with the tax obligations, which mission is the essence and reason of existence of our Tax Offices. On the other, there is ”tax evasion”, ill-fated variable which must be combated without respite, due to the serious consequences it entails for the equity of the tax system, tax collection and the very economy of the countries, since it is a source of unfair competition among economic agents.

Now then, these two factors, examination and evasion, are closely linked, in a relation of causality, in such a way that the deficient management of the examination area by the Tax Administration shall give way to greater evasion. On the contrary, an efficient performance of the examination function will contribute to reduce this pernicious phenomenon.

Within this framework, at the next Assembly in Santiago we will be able to analyze the factors involved in tax evasion and the mechanisms and strategies for reducing it.

In the past decade, in Chile, we have had significant achievements in reducing evasion, although we are totally convinced that we have still much to learn from the other countries.

The exchange of experiences between the Tax Administrations of CIAT, especially with respect to the struggle against tax evasion is an excellent opportunity for sharing experiences and knowledge, through the lectures scheduled in the program, as well as the informal conversations outside the meeting rooms.

I am certain that all those of us who are responsible for heading the Tax Administrations of this Continent share this same vision.

Statement by the CIAT Executive Council President

Bob Wenzel
Deputy Commissioner
Internal Revenue Service
United States

Bob Wenzel

In recent years, we have seen increasing collaboration among our member tax administrations to address tax compliance issues in an effort to combat tax avoidance and evasion. We are beginning to see positive results from our efforts. This week we will continue to focus on the fiscal harm of tax evasion and discuss how to address the problem through our tax administration examination process.

The theme of this 35th General Assembly is "The Tax Administration's Examination Function and Control of Evasion". Our ultimate goal is to eliminate tax evasion in today's complex, global commercial market. Our examination functions continue to be one of our best defenses and preventive measures to ensure that all taxpayers contribute their just amount of taxes. To achieve this goal, we need to equip our staffs with the necessary knowledge and tools in combating tax evasion.

In this 35th General Assembly, we will examine the means available to us in order to effectively control evasion. We will begin with topícs such as, "The Reduction of Tax Evasion as a Means of Fiscal Financing" and hear how our States' financial resources are eroded through evasion. Other speakers will touch on the great value of requiring and enforcing routine reporting of certain economic activity and bank transactions. And lastly, we'll discuss how mutual cooperation among our members provides another avenue to address the growing problem of tax evasion beyond our borders.

Our Chilean hosts have put together an excellent program. I am certain that we will all benefit from the presentations to be delivered by our colleagues. I look forward to seeing friends and colleagues again.

Thank you

35th CIAT General Assembly
"The Tax Administrations's Examination Function and Control of Evasion"
Santiago de Chile, April 2 - 5, 2001

TOPIC 1

THE REDUCTION OF TAX EVASION AS A MEANS OF FISCAL FINANCING

Lecture:

TOPIC 1

THE REDUCTION OF TAX EVASION AS A MEANS OF FISCAL FINANCING

Javier Etcheberry Celhay
Director
Internal Revenue Service
(Chile)

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1. PUBLIC FINANCING AND TAXES

1.1 Importance of tax revenues in the financing of public spending

A fundamental objective of the tax system is to provide the necessary resources to contribute to financing public spending. This objective is known as the *sufficiency* of the tax system. If it is, in fact, true that taxes are not the only source of fiscal financing[1], it is a fact that they

[1] *Other mechanisms whereby it obtains financing are the income generated by publicly owned assets, such as the profits generated by public companies (oil revenues are an illustrative case); resources obtained from the sale or privatization of such assets; and of course, resources obtained from public debt.*

mark a very important signal regarding the commitment and efficacy with which the State may execute its functions. Additionally, they may, to some degree, also condition access to other sources of income[2]. As stated in CEPAL [1998] the objective of sufficiency in collections is a crucial element to make the "fiscal pact" come true, that pact which determines the role of the State and its scope and reach in the economic and social areas.

The world trend toward the search of balanced fiscal budgets and the adoption of rules of fiscal discipline in various countries corroborate the absolute relevance that, on the side of income, the objective of tax sufficiency has and will have. In the case of Latin American countries, the problem in this area is well known. With an average tax pressure that does not exceed 15% of the GDP[3], various countries of the region view their fiscal performance seriously affected by that reason. In the case of developed countries, whose average tax pressure doubles[4] that of Latin American countries, the problems of sufficiency seem much less urgent. Today, however, such phenomena as the displacement of tax bases, transnational evasion and avoidance, electronic commerce, and noxious fiscal competence, are all posing very significant challenges to their fiscal objectives, even with independence of the degree of development of their economies.

On the other hand, one must also take into account the existing relationship between tax sufficiency and social development and equity. Diverse empirical studies have demonstrated that public spending, especially on education and public infrastructure, exerts positive impacts on economic growth, which justifies the effort of seeking adequate collection levels to meet such functions (Serra [1998]). Moreover, it is becoming increasingly clear that financing public spending appears to be the most effective[4] mechanism to achieve social equity.

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[2] *In various countries, the State views its access to credit limited when it does not maintain adequate collection levels, because it represents a record of its payment capacity.*

[3] *Average taking into consideration tax burden without social security of the countries included in the sample of table N° 1, which is presented below.*

[4] *Engel et al [1998] has found that in Chile the most important redistributive effect comes from social spending which is financed with taxes, before the progressiveness of its collection. Moreover, he concluded that the VAT is the most effective tool to redistribute, precisely because of its great performance as an instrument generating fiscal resources.*

Table N° 1
Central Government Tax Burden
(Figures in %)

Country	Includes Social Security[1]	Does not include Social Security[2]
Sweden (1998)	52.5	48.4
Canada (1995)	36.0	33.1
Israel (1998)	38.8	32.8
Italy (1998)	43.6	31.1
New Zealand (1997)	31.0	31.0
United Kingdom (1998)	37.0	30.4
South Africa (1998)	29.7	29.2
France (1997)	43.5	26.0
Portugal (1997)	33.1	23.8
Germany (1998)	37.5	22.2
USA (1998)	28.9	22.1
Spain (1996)	32.8	21.3
Brazil (1994)	29.3	21.2
Uruguay (1998)	30.0	20.5
Japan (1993)	25.9	20.2
Chile (1999)	**20.1**	**18.6**
Malaysia (1997)	19.4	19.1
Philippines (1997)	17.5	17.5
Bolivia (1998)	18.7	17.4
Korea (1997)	18.6	16.6
Singapore (1997)	16.0	15.9
Argentina (1997)	21.1	15.4
Indonesia (1998)	15.3	15.0
Colombia (1994)	17.0	14.7
Mexico (1997)	16.5	14.7
Ecuador (1994)	13.9	13.9
Panama (1998)	18.2	13.2
Peru (1997)	14.0	12.7
Guatemala (1996)	9.7	9.7
Paraguay (1993)	10.9	9.3
Average	**25.9**	**21.3**

Source: Prepared by the SII Studies Subdivision, based on IMF-1999.

Notes:

[1] Tax revenues of the Central Government as a percentage of the GDP, for the last available year. The tax revenues of the Central Government comprise budgeted and non-budgeted tax collections of the Central Government as well as State, Regional, Provincial and/or Local Governments. Due to lack of information, tax revenues of supra-national authorities have been excluded.

[2] Refers to the social security contributions the Central Government collects.

1.2 Tools for Increasing Tax Collection

In principle, collection is determined by two factors. First, by the size of the tax base, that is, by the magnitude of the variable or economic event that is being taxed; second, by the tax rates applied on the tax base. This, in a world where all taxpayers fulfill their tax obligations, would determine when taxes are collected. Nonetheless, the reality is that some taxpayers do not make their tax payments and, therefore, collections are hampered by this third factor, tax evasion. Assuming that collections concentrate on a *B* tax base tax, with a *t* tax rate and whose level or evasion rate is equal to e, effective collection *R* may be expressed as:

$$R = B*t*(1-e)$$

It then results that the tax policy has three tools to promote increases in collections: broadening the tax base, increasing the tax rate and reducing tax evasion. Each of these tools implies different levels of collection effectiveness and a different commitment with the other principles of tax policy: efficiency, equity and simplicity. Below we will briefly review those elements.

- Increasing tax rates

Intuitively, an increase in tax rates is often associated with a proportional increase in collections. Theoretical models suggest, in turn, that the impact of increasing the rate on collection is not always proportional and might even be negative. As regards the tax on work-related income, individuals respond to a tax increase by redistributing work (tax) and leisure (non taxed). If tax rates are already high, increasing them could generate counterproductive effects on collections.

On the other hand, a tax rate increase involves a very significant cost of efficiency. As regards progressive taxes on income, high rates are associated with distortions to the savings and investment processes and with negative incentives to the additional effort of individuals. To the above one must add the fact that higher rates might induce larger tax evasion and avoidance, which is another severe cost in terms of efficiency, which by the way, may offset the performance of collections. These reasons have led a recent trend toward reducing higher income marginal rates, which has gone hand in hand with a gradual increase in VAT rates (Owens [1998]).

- Broadening the tax bases

An important factor reducing collections is the limitation of the tax base, through exemptions, exoneration, deductions and special treatments. The reforms made in Latin America in the 1980s attempted to eliminate exemptions and broaden the tax base. Nonetheless, at present there are still a good number of goods and services that are exempt. The reasons most commonly mentioned to justify these exemptions are, among others, reducing the regressiveness of the tax, furthering the consumption of goods or services deemed appropriate and the difficulty to tax certain products.

The elimination of exemptions may be an important source for the increase of fiscal resources. At the same time, there is evidence indicating that efficiency and simplicity benefit from measures that eliminate special treatment. However, what undermines the viability of this type of reform is the reluctance to eliminate exemptions with some content of social equity, despite the fact that as was mentioned before, equity on the side of public spending is much more important.

- Reducing tax evasion: a superior alternative

The third tool that is available to increase collections is the fight against tax evasion. The phenomenon of tax evasion is present in nearly all tax systems, although in varying degrees and with different features and characteristics. In more developed countries, the levels of evasion are 10% or less. In those countries, tax spending[5] accounts for even higher figures, which explains the marked significance such issue has –before tax evasion– as a source of potential resources. On the contrary, in Latin America the level of tax evasion of the countries is 30% or more, with a generally lower figure of potential income from tax spending.

Reducing tax evasion also has benefits from the standpoint of efficiency and equity. Tax evasion constitutes a factor of disloyal competition of those evading taxes in relation to those who comply. Later, if it is reduced, one contributes to a better distribution of resources. By reducing tax evasion, one also promotes an atmosphere of greater compliance in other areas of the economy. By reducing tax evasion one also paves the way for a reduction of

[5] *"Tax spending" (or tax waiver) represents the tax revenues that are not collected due to the exemption regimes that lessen the tax base or from special reduced rates.*

tax rates and, therefore, a lessening of distortions. In summary, when compared with other forms of collection, this seems to be a superior alternative.

1.3 Variables That Have An Impact on Tax Evasion

Economic theory models the decision of evasion of an individual as a selection of risk. Indeed, it establishes that it will depend on his income, the tax rate, the probability of detection and the fines to be evaded. Regarding the last two variables, the Tax Administration plays a fundamental role.

The examination function. The probability of detecting tax evasion depends on the resources and powers the Tax Administration may have to verify as well as on the effectiveness with which it administers those resources. One must bear in mind that more than the real probability of detection the dissuasive effect is due to the probability "perceived" by taxpayers. A clear example of this is the feeling of control produced among taxpayers by the fact of knowing that the Tax Administration has cross information to verify their tax returns[6].

The penalty system. The application of the penalty system usually falls under the responsibility of the tax authority, which has a direct impact on the greater or lesser effectiveness with which tax evaders are penalized. Indeed, the Tax Administration is responsible for the task of expediting the penalty application procedures and improving the juridical righteousness of its actions, which are essential to dissuade the tax evasion behavior. The perception of "just" actions from the Tax Administration is an equally important factor in this area.

Acceptance of the System, Cost of Compliance and Social Commitment. Other variables of equal or more importance must be added to the risk model variable. They include such variables as the simplicity of the tax structure, costs of compliance (that is, the expenses incurred by taxpayers in meeting their tax obligations), the degree of acceptance of the tax system, the degree of commitment of citizens with government institutions and social awareness. A recent study

[6] *In 1995, powers were granted to the SII to request information on interest paid to each taxpayer from banks. In operation income of this year, the delivery of information still had not come true, however, interest declarations grew that same year.*

on the case of Chile profiles different types of taxpayers with respect to fraud, showing the special significance the social context variables have in the decision to evade taxes (Mori [2000]). If it is, in fact, true that the Tax Administration does not have a direct influence on these variables, it may also have a direct impact on various of them and with great effectiveness.

After all these events are recognized, the problem that arises next is how the tax policy may use the different variables in favor of reducing tax evasion. Below we will briefly go over some aspects of the Chilean tax system, in order to provide context to the analysis of the following chapters.

2. CENTRAL ASPECTS OF THE CHILEAN TAX SYSTEM

2.1The Tax Burden

The Tax Burden (or Tax Pressure) expresses the taxes collected in a year as a percentage of the GDP. Economically speaking, the tax burden is a measure of the value of goods and services that are transferred to the State every year so that it can carry out its functions.

Chile has a net tax burden[7] relatively low when compared to those in traditional developed countries, with a net tax burden of 20% and above, even reaching levels in excess of 35%. It should be pointed out that the Chilean tax burden is similar to that in Asian emerging economies such as Indonesia, Singapore and Korea.

When comparing the Chilean tax burden with that of Latin American countries, Chile has one of the highest tax burden in the regional context. This level of collection is not explained by the fact tax rates in Chile are higher, but basically because the levels of tax evasion are lower than those observed in the rest of the Latin American countries.

[7] *The net tax burden, that is, excluding social security contributions is a relevant distinction when compared internationally, given that in some countries there are private security systems. Consequently, State social security collections will evidently differ from those in countries where social security is state-owned. Chile, for example, is one of the countries where most social contributions are managed by a private system.*

2.2 The Tax Structure

- Collections by tax

In Chile, tax revenues display a strong concentration of internal taxes on consumption. Among them, the VAT is the most important one by contributing a figure close to half of overall collections.

Table N° 2
Central Government Net Tax Income.
Year 1999. Figures in nominal currency

	[Mill. $]	[Mill. US$][1]	[% of Total]	[% of GDP]
Tax Revenues Collected	**5,805,793**	**11,411**	**100.0**	**16.9**
Income Tax	1,312,195	2,579	22.6	3.8
Value Added Tax	2,811,585	5,526	48.4	8.2
Taxes on Specific Products	817,769	1,607	14.1	2.4
Taxes on Legal Proceedings	245,417	482	4.2	0.7
Net Foreign Trade Taxes	535,490	1,052	9.2	1.6
Others[2]	83,337	164	1.4	0.2

Source: Budget Directorate

Note:

[1] The average exchange rate prevailing in 1999 is used, that is, $508.78 to the US dollar.
[2] Includes Tax on Inheritance and Donations; Tax on Gambling; and tax revenues from Readjustments, Penalties and Interest.

The 1999 tax revenues indicate total collections reached a US$ 11,411 million. Of that total, 22.6% are collected from the income tax, to include the corporate and individual income tax. The corporate income tax includes the First Category Tax with a 15% rate, the Additional Tax paid by foreign companies and the Additional Tax paid by state-owned companies. The individual income tax includes the Second Category Single Tax and the Complementary Global Tax. The VAT accounts for 48.4% of collections. The special taxes on consumption (Tax on Alcoholic, Analcoholic and Similar Beverages; Tax on Luxury Products; Tax on Vehicles, Tax on Tobacco, Cigars and Cigarettes and Tax on Fuel) totaled 14.1% of collections. An estimated 9.2% of tax revenues were obtained from tariffs.

- Principal characteristics of the VAT

The VAT in Chile is characterized by being a tax with a relatively broad base, which operates at a single 18% rate and which does not contemplate special tax regimes. These features explain to a large extent that it is the most productive tax of the tax system, as inferred from the preceding section. Indeed, the VAT in Chile taxes most sales of assets and real estate, the latter belonging to a construction company, as well as the rendering of services that are made or used in the country. It affects the State Treasury, semi-fiscal institutions, autonomous administration entities, municipalities and companies thereof or in which they have participation, albeit tax-exempt from other laws.

The principal tax exemptions fall on health, education, public transportation and financial interest. In addition, there is a mechanism in place to take advantage of the remaining fiscal credit accumulated for six or more consecutive months when it originates from the purchase of fixed assets. Moreover, and as happens in most tax systems, exporters are exempt from the VAT for their oversea sales, and they are given the right to recover the VAT caused by purchases intended for export.

- Principal characteristics of the Income Tax

There are three fundamental principles on which the Chilean Income Tax is based, which must necessarily be taken into account to be able to understand the logic behind the tax. The first principle is that the subjects of taxation must ultimately be individuals; the taxes that companies' pay corresponds only to the personal taxes their owners must pay. The second principle is that the tax base must consist of the set of income received by the person for the tax period, which is called the principle of global income. The third principle is that the tax must be used as an income redistribution tool, which is done by way of a progressive rate scale.

These three principles materialize in the so-called Complementary Global Tax, which is a personal and progressive tax with rates from 0% to 45%. This tax must be declared and paid every year by resident individuals, with the exception of those who only obtain income from dependent work relationships. Nearly all forms of income obtained

for the tax return period converge on the Complementary Global Tax, such as fees, retirement from companies, dividends, capital gains, salaries, etc. The above reveals the “globalized” nature the tax has. It should be pointed out that the Chilean legislation also applies the principle of world income, whereby resident individuals must declare both Chilean-source and outside-source income.

When nonresident foreign individuals obtain income, the Complementary Global Tax is replaced by the Additional Tax. This tax affects the income sent overseas and applies a 35% general rate, or any of the special rates depending upon the quality of the income.

Now, conceptually speaking the law classifies income in two types: capital income and work income. The former is called First Category income and is subject to the Tax bearing the same name, with a 15% rate. The First Category Income can be credited against the Complementary Global Tax (or Additional Tax) as a result of its “payment on account” nature we described above. The work income is the Second Category income and, when it comes from a dependent work relationship, is subject to a Second Category progressive tax, which is withheld monthly by the employer and may also be credited against the Complementary Global Tax [8]. In turn, when it comes from self-employment, income is only taxed with the Complementary Global Tax, applying a withholding or provisional payment of 10% on the gross income at the time it is earned.

Moreover, the Chilean income tax contemplates a series of mechanisms called savings incentive mechanisms. They are basically mechanisms for the deferment of tax on saved income (Article 57 bis) as well as the possibility of deducing from the tax base 50% of interest and dividends, 20% of investments in payment actions and social security contributions. Incentives to investment come from the rate gap, a credit to the corporate tax of 4% on fixed assets, the accelerated depreciation mechanism.

[8] *Excludes the possibility of crediting taxpayers who only obtain income from dependent work relationships, for whom the Second Category Tax is a final tax.*

3. STRATEGIES AND ACTIONS TO REDUCE TAX EVASION IN CHILE IN THE 1990s

3.1 Situation of the Country in 1990

The year 1990 marked a fundamental change in the political, social and economic reality of the country. After 17 years with a military government in office, the country returned to a democratic system with elected officials, and the functioning of traditional Republican institutions such as the Parliament was restored. From its inception the new administration had to face not only political problems resulting from the change of system but also the social and economic effects of the policies implemented during the military regime.

Indeed, the Chilean economy had experienced radical changes during the previous regime, making way for a market economy characterized by a strong opening of internal and external markets, a reduction of the traditional role the Chilean State had played as advocate and promoter of the country's development. This paved the way for private initiative to undertake new businesses and take over several companies and activities that until then were run by the state. These changes in the economic structure were accompanied by large changes in such areas as education, health and the social security system, which had a broad social repercussion. From systems in which the state provided subsidies or broad benefits, the country went to services supplied by private companies that had to be paid for by users themselves.

In the meantime, the fiscal budget and the sources of public financing showed the effects of these new orientations and structural changes. In particular, important items related to "social spending" (subsidies, benefits, resources to education and public health) were reduced, contributions to state-owned companies that were sold (bid to the private sector) were eliminated, resources were obtained from the sale of assets or those same companies, etc. At the same time, and in keeping with the objective of furthering the development of a strong private sector, the resources assigned to state-owned entities were cutback. This included tax examination entities, which limited their possibilities of effectively fulfilling their control work.

The Chilean Tax Administration, which in the 1980s lost approximately half of its staff, did not escape this situation. This seriously undermined the Administration's examination, collection and recovery capacity. Thus, as the situation stood in the early 1990s, tax evasion reached rates close to 30% for the VAT and 49% for the first category tax.

Despite the fact the country's Gross Domestic Product grew at high rates, the poor income distribution among the population generated a growing discontent of middle sectors and a significant increase in the levels of extreme poverty.

With this prevailing situation, the new democratic government assumed as one of its programmatic bases resolving this historical "social debt." To obtain the necessary financial resources, it proposed a Tax Reform that basically involved increasing the corporate profit tax rate from 10% to 15% and increasing the general VAT rate from 16% to 18%.

Obtaining these new resources became the great challenge for the leaders of the Chilean Tax Administration[9] appointed by the new government, while recovering and as much as possible increasing the traditional levels of effectiveness and efficiency in the fulfillment of their functions. Despite the fact the fulfillment of this challenge involved the commitment of three services –Internal Revenue Service (SII), the Treasurer General's Office and the National Customs Service–, the SII is primarily responsible for this task. Therefore, from this moment on, the concepts expressed will be dealing exclusively with the SII.

3.2 New Guidelines for the Management in the 1990s

Below we summarize some concepts and guidelines that characterized the SII management during the 1990s. It must be clarified that not all of them were clear from the outset. The work of directors in conjunction with the active participation of mid-level and junior officials allowed us to produce some guidelines that are presented.

[9] *It should be pointed out that in Chile, the Tax Administration consists of three different autonomous entities, namely: the Internal Revenue Service, responsible for the examination of internal taxes; the National Customs Service, in charge of import duties and tariffs; and the Treasurer General's Office, in charge of the collection and recovery of taxes (among other non-tax financial services to the State)*

- A new focus of management

Bearing in mind the need to obtain resources to be able to finance new programs of democratic governments, the first objective will be to collect more. This had to be done without making changes in the governing structure of the Tax Administration or the powers and resources it had.

Thus, it became necessary to collect more while being more efficient and effective, so the internal transformation of the SII was fundamental. This required a strong commitment to train officials and establish a clear and defined leadership in management, in order to advance pragmatically in the modernization of the SII to bring it in line with the commitments acquired.

- The principal landmarks of modernization.

a) Establishment of a clear leadership and a professional and efficient chain of command

From the moment of his designation in 1990, the current SII Director undertook the establishment of a top professional and competent management team, whose motivation would focus on achieving objectives more than on compliance with norms and procedures. It is a team with a strong orientation toward innovation and generation of permanent change processes. At the same time, a management and decision-making style was established, based on the previous participation and discussion of problems and solutions with the directors of the areas involved. This entailed the commitment and involvement of junior officials in said solution. The participation of third parties (associations, accountants, etc.) contributed to validate the decision of the administration and to create an open and transparent management style. All of these elements contributed to validate the management and leadership style of the administration both internally and externally, thereby getting the support of directors, officials, Ministry of Finance and Government authorities in general.

c) Integrity

One of the fundamental elements for the success of the struggle against tax evasion is to make the Tax Administration completely immune to corruption. Should corruption permeate the organization, it may offset management's efforts to try and reduce tax evasion. In Chile, there have been few instances in the SII where actions affecting the integrity of officials have been detected. Nonetheless, management has created an absolutely clear policy of "zero tolerance" to face this type of practice. To that end, it has faced the problem in a public and systematic manner within the Service, holding workshops with officials to discuss and address the problem, its causes and ways to prevent attitudes or actions that may undermine integrity (the politicization of decisions is also a breach of integrity).

On the other hand, the Service's management has clearly and decisively penalized those officials who have committed faults or crimes related to integrity, to include their expulsion from the SII. Even so, to guarantee the transparency and justice of the procedures that are employed in the investigation of each situation, a Controller's Office was created in the SII, under the direction of a Controller who holds the rank of Deputy Director. He is responsible for presenting investigation summaries and proposing penalties to the Director, as well as for following up on the issue within the SII.

The pressure and criticism of the zero tolerance policy from different sectors, such as workers themselves, their trade unions or even lawmakers, has been broad. They view in this type of policy a threat to the work stability of officials or the danger for the commission of irregularities. The Comptroller General's Office, a controlling entity of the Chilean State, often times has faced appeals denoting reluctance to adopt drastic decisions.

If, in fact, those difficulties exist, they are not grounds not to maintain strict policies. In order for strict policies to subsist, they must be based on the prestige of a successful administration in other aspects of the management of Services.

d) Taxpayer Service

One of the basic elements of the strategy to increase collections was improving taxpayer services, so as to further voluntary compliance with tax obligations, and in general reducing compliance costs of the same, both in terms of money and time to conduct the paperwork. In the middle 1990s the reengineering of the principal formalities taxpayers carried out at the SII got under way, streamlining processes, eliminating unnecessary paperwork and trying to complete taxpayer paperwork in one SII visit. To further this type of action, guaranteed public commitments were established, where in most cases taxpayers would not have not wait more than 30 minutes to be called on and where their paperwork would be completed in one single visit to the Service, provided they met the corresponding requirements. Otherwise, the completed paperwork would be taken to the address the taxpayer indicated.

The improvement in taxpayers' access to the SII, which in the beginning was based on the opening of new Service units in various parts of the country[11], gradually paved the way for different forms of the Service – Taxpayer relationship, as taxpayers employed the facilities and advantages of the Internet. Regarding the use of this latest technology, its quick development has enabled us to move from a period of information to the taxpayers to a transactional stage. In it, the taxpayer can file his income tax return, pay taxes electronically and file corrected returns when necessary based on the observations the SII may make, as a result of its review and examination processes, as well as request certificates and carry out many other transactions.

e) The New Strategies of Examination

Consistent with a greater deepening and professionalization of examination tasks, they evolve from an equal handling of taxpayers, at best differentiated by location, to a segmented focus of taxpayers, based on the types of activities they carry out, their type of business, different sizes, historical tax behavior. This allows for a detailed work of examination, improving the use of resources while increasing the probability of correct actions in control and auditing work.

[11] *By the middle of the decade, the number of SII Units could not continue to increase because of the high cost it had and the lack of additional resources to undertake such tasking.*

The segmentation of taxpayers resulted in examination plans and procedures, which are increasingly accurate and specialized. They were gradually improved in terms of making a better selection of the cases to be checked, as well as the procedures and routines to follow in the processes. Such processes eventually reached high levels of standardization.

On the other hand, the modernization of the SII in the field of computers permitted the information the SII had on taxpayers, their activities and tax behavior, to evolve toward more integrated (between applications and nationwide), reliable and on-line systems. The information the SII had was historically broken up in various systems and often contradictory or plain wrong. Such modernization enabled officials to be in contact in a timely manner with important data for examination, significantly improving the quality of computer support to the actions of auditors

The efforts to utilize the information that was available, which was supplied by taxpayers in their returns or in audits, were complemented by the improvement of the relevant information for tax purposes, requested from third parties on those taxpayers (for instance, interest paid by banks). This resulted in massive processes of exchange of information with similar data obtained from more than one source.

The strong growth and expansion of the SII computer storage and processing capacity in the last few years has improved the processes to detect inconsistencies, nonfilers and other observations. They have significantly improved the SII's ability to detect noncompliance or simple tax evasion.

Finally, the management focus applied to the tasks of examination has made it necessary to have a more careful and detailed planning of available resources and their distribution, developing also a management control system all along the way. With it, progress has been made on the management of "we do what we can" examination approaches to approaches in which an objective follow-up of actions undertaken and results are done. This allows for the adoption of corrective measures that lead to a systematic improvement of results.

f) Legality [12] and Equity

One of the permanent concerns of the SII management throughout last decade was and continues to be that the actions of the Service be consistent with legality and equal treatment to taxpayers at all times. Significant innovations were made to cope with this aspect, which was deemed crucial in the modernization of the Service.

On one hand, legal control in the preparation of all kinds of norms and instructions to taxpayers and officials was strengthened, incorporating into their processes the appropriate training plans for officials implementing such norms.

On the other hand, in order to correct erroneous actions, formalities and procedures of administrative review of such actions associated to examination operating units have been generated. Such actions provide the capacity to amend the errors that have been made.

Much before, the way in which the SII received and handled taxpayer claims had been reorganized. This authority originally resided with the regional tax authority, resulting in the establishment of the Tax Courts in each SII Regional Directorate. Although they continue to be apart of the Service organization, they have been given operating autonomy and an attorney with the title of judge has been named to head them. The operation for many years of this first entity of "tax justice" enabled authorities to accept, totally or partially, approximately 50% of taxpayer claims and to reduce case processing time to 3.5 months on average.

g) Development of the SII permanent capacities

One of the key factors of the SII modernization is maintaining the ability to adapt and anticipate changes in their external context, particularly in an increasingly globalized world where technology has taken on a more important role. From its beginning the administration emphasized placing taxpayers as the center of procedures and processes, in accordance with the prevailing trends of focus of attention on the client. This brought a review of most

[12] *We talk here about legality and not justice because the latter must be implicit in the law and in Chile the administration is not responsible for defining the tax policy and drafting the law; it is just responsible for applying it.*

processes (reengineering) in order to simplify and make them more efficient and effective. Numerous projects were carried out covering complete areas of SII activity, such as the Taxpayer Lifecycle, the tax court, Operation Income, Operation VAT, Appraisals and many more.

In addition, the strategic value for examination of having and administering correct and timely important information, in a context of relatively scarce budget resources, led to a complete revolution in the field of computer technology. This created an infrastructure of computer networks through which every official could interact directly and at all times, in real time, with databases that are permanently being updated on line. Such handling of information and such broad access to it by officials[13] has permitted authorities to significantly increase the productivity of the examination and administrative work of the Service.

In the last few years the SII has strategically pledged to use the Internet and its technological tools, both in its internal operation (Intranet) and its relationship with taxpayers (website: http://www.sii.cl). From the initial applications, in which the objectives were to provide information and communication through an electronic mail, today one can file different income tax returns on the Internet, make electronic payments, file corrective returns voluntarily or from mistakes by the Tax Administration. One can follow up on the review process of each tax return in the Service, grant taxpayers access to the information the Service has, and obtain many payment certificates and receipt duplicates. Internally, the use of the Intranet and associated technologies has resulted in conducting internal operations quickly and without paperwork, with the ensuing simplification and streamlining of procedures.

The growing technologization of the Service's work has brought about new problems to resolve, such as the high dependence on continuing and optimum operation of those same technologies and the privacy that must necessarily be preserved of data and internal transactions as well as transactions with taxpayers.

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[13] *By late 2000 every SII official had a PC connected to a national network, with access to every SII database (access is limited by way of a profile and privilege structure in accordance with the official's position), an Intranet (e-mail, information and operating applications) and Internet network.*

h) Learning from other Tax Administration and Institutions

Regarding management, a good and common practice in the private sector is benchmarking with similar companies, identifying those better practices to adapt them to one's own management (benchmarking). Meanwhile, tax administrations generally do not have in their countries similar entities, which will enable them to do benchmarking and learn from what others have done. Nonetheless, in Chile this practice was adopted by doing benchmarking with other tax administrations of the world, especially those with better indicators of tax compliance and management. Under this perspective, the valuable work of CIAT in this area should be pointed out together with the CIAT's support to the information demands of the SII from other tax administrations.

One of the latest SII experiences in this regard was requesting France's DGI cooperation so that DGI officials could make a SII assessment, following the same guidelines of a study conducted by the DGI for 10 countries of the developed world in Europe and North America. The purpose of this request was benchmark the SII with the results of said study.

These practices have enabled the SII to learn and understand why other tax administrations have achieved success, highlighting those aspects that must be improved and establishing the possible scope of such improvements. This allowed SII authorities to present substantiating information for projects before Ministry of Finance authorities, especially Budget officials, as well as support some legal amendments submitted to the parliament.

An additional comment from the Chilean experience is that the practice of benchmarking has not only been made with tax administrations from other countries but also with various other public or private entities or companies who conduct similar activities to those of a tax administration. Consequently, for example, concerning customer service we do benchmarking with what companies providing banking and social security services do. Regarding our Internet service, we do benchmarking with many companies who interact with clients on the web, much the same way the SII does, and so on.

i) Strategic 1995-2000 SII Plan

In 1995, the SII produced its first Strategic Plan, which explained in a coherent and consistent manner the management focus that prevailed and the principles action lines of the Service for the 1995-2000 period. It quickly became a basic instrument for a more decentralized and autonomous action of the different Regional Directorates. To date three updates have been made.

From the Plan, below we reproduce the definition of the Mission for the SII:

> *Mission. The Internal Revenue Service is responsible for applying and administering the internal tax system as well as for overseeing taxpayers to ensure they comply with tax provisions and to facilitate such compliance*

This same document defines the following strategic objectives:

Strategic Objectives

- *Improve the efficiency and productivity in the permanent work of the Service.*
- *Promote the professional and personal development of officials, their motivation and support for the Service and ensure the compliance of legal and ethical obligations of public duty.*
- *Reduce the levels of tax evasion and avoidance.*
- *Facilitate tax compliance and improve taxpayer services.*
- *Safeguard the equity and righteousness in the application of the tax law.*
- *Strengthen and develop the abilities of the Service to fulfill its mission and become an active player in the development of the country's economy.*

3.3 The Resources

Below, in Table N° 3, we depict the evolution of human resources at the SII for the 1990-1999 period. It can be seen that while in 1990 the number of officials totaled 2.170, in 1999 that indicator reached 2.953 officials. This is equal to a 36,1% increase between both years. If we look at the number of auditors alone, we can see a 39,1% percent increase.

Table N° 3
Total Number of Officials and Auditors

Year	Total Number of Officials	Variation	Total Number of Auditors	Variation
1990	2,170		734	
1991	2,211	1.9%	722	-1.6%
1992	2,337	5.7%	829	14.8%
1993	2,384	2.0%	762	-8.1%
1994	2,539	6.5%	811	6.4%
1995	2,555	0.6%	800	-1.4%
1996	2,549	-0.2%	792	-1.0%
1997	2,577	1.1%	816	3.0%
1998	2,690	4.4%	914	12.0%
1999	2,953	9.8%	1.021	11.7%
Var. 99/90	***783***	***36.1%***	***287***	***39.1%***

But not only SII resources have grown. The economy also did, reflecting a bigger number of taxpayers who must be serviced and overseen. Table N° 4, shown below, depict the evolution of the number of taxpayers in the three principal segments of taxpayers: First Category, Complementary Global and VAT.

Table N° 4
Number of Annual Taxpayers by Tax

Year	Taxpayers							
	Income	Variation Tax	First Category	Variation	Complem. Global	Variation	VAT	Variation
1990	982,727		452,557		689,274		475,089	
1991	1,076,684	9.6%	470,000	3.9%	733,520	6.4%	494,105	4.0%
1992	1,185,503	10.1%	498,032	6.0%	819,502	11.7%	527,085	6.7%
1993	1,286,616	8.5%	525,565	5.5%	896,281	9.4%	550,415	4.4%
1994	1,368,869	6.4%	557,694	6.1%	958,370	6.9%	570,465	3.6%
1995	1,481,370	8.2%	577,426	3.5%	1,043,165	8.8%	593,308	4.0%
1996	1,605,823	8.4%	594,504	3.0%	1,142,363	9.5%	630,789	6.3%
1997	1,694,688	5.5%	619,532	4.2%	1,207,001	5.7%	646,381	2.5%
1998	1,781,744	5.1%	641,640	3.6%	1,268,973	5.1%	650,744	0.7%
1999	1,832,384	2.8%	664,602	3.6%	1,345,073	6.0%	671,273	3.2%
Var. 99/90	**849,657**	**86.5%**	**212,045**	**46.9%**	**655,799**	**95.1%**	**196,184**	**41.3%**

The preceding table highlights the sizable growth experienced by the number of Income Tax taxpayers. This is basically explained by the increase in the number of taxpayers who declare the Complementary Global. The explanation lies in the better examination of this tax and in the greater availability of SII information, which induced many taxpayers, who did not do it before despite being mandated to do so, to file their tax returns.

Setting this effect aside, and focusing only on the increase in the number of companies, we see that between 1990 and 1999 those who declare the First Category tax grew by 46.9% while those subject to the VAT grew by 41.3%. Both figures are larger than the increase in the number of SII staff, which means that today every auditor has on average a larger number of taxpayers than in 1990, as shown in the table below. This increase in the service load has been accompanied by greater taxpayer demands in service quality and also by bigger complexities in the operations to be controlled. Such aspects are typical of the Chilean economy dynamics in the 1990s.

Table N° 5
Number of Annual Taxpayers by Auditor

Year	Income Tax Taxpayers	VAT Taxpayers	SII Auditors	Income Taxpayers by Auditor	VAT Taxpayers by Auditor
1990	982,727	475,089	734	1,339	647
1991	1,076,684	494,105	722	1,491	684
1992	1,185,503	527,085	829	1,430	636
1993	1,286,616	550,415	762	1,688	722
1994	1,368,869	570,465	811	1,688	703
1995	1,481,370	593,308	800	1,852	742
1996	1,605,823	630,789	792	2,028	796
1997	1,694,688	646,381	816	2,077	792
1998	1,781,744	650,744	914	1,949	712
1999	1,832,384	671,273	1,021	1,795	657

3.4 The Results

- Reduction of VAT Evasion

With respect to the VAT, the most important tax in terms of collections, the levels of VAT evasion[14] were significantly reduced. At the beginning of the 1990s, the evasion rate of this tax bordered 30%. This figure was progressively reduced to a level between 19 and 20% by the end of the decade. It is important to note that the reduction in VAT evasion has been achieved despite the hike in the tax rate (by the mid 1990s it went from 16% to 18%), an element that in the opinion of many people would hamper the objective of tax compliance.

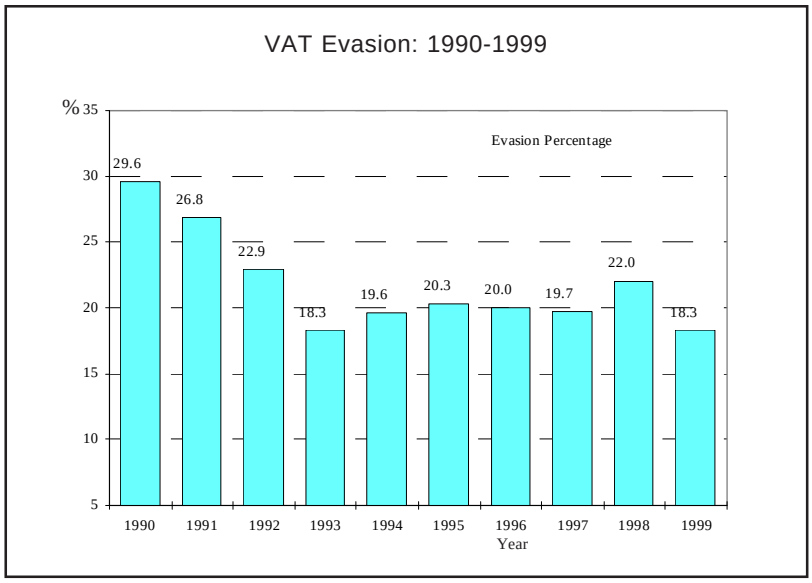
Table N° 6
Net VAT Evasion[1]

Year	Amount of Evasion		Rate of Evasion
	[Mill.$sep99]	[Mill.US$sep99]	[%]
1990([2])	621,132	1,184	29.6
1991	648,123	1,236	26.8
1992	621,817	1,185	22.9
1993	524,665	1,000	18.3
1994	587,851	1,121	19.6
1995	658,941	1,256	20.3
1996	685,717	1,307	20.0
1997([3])	715,043	1,363	19.7
1998([3])	820,639	1,564	22.0
1999([3])	651,979	1,243	18.3

Source: Department of Studies - SII, based on information from the Central Bank.

Notes:
1 The 'net VAT' covers the collection of the General Rate VAT and the General Import Rate VAT.
2 As of June of 1990 the VAT rate totaled 16%. Beginning in July of that year, that rate was changed to 18%. In order to estimate the evasion amount, an 18% rate for collections has been used.
3 Provisional figures.

[14] *In order to determine the evasion rate estimation methodology, please check Topic 1.3 "The Instruments for the Measurement of Tax Evasion." prepared by the SII for this 35th CIAT General Assembly, Santiago, Chile.*



Now, compared with other countries, the level of VAT evasion achieved in Chile at the end of the decade placed the country as the best in terms of compliance in Latin America, as shown on table N° 7. It can be observed that this level, however, is still below the level of compliance shown by highly developed countries, where the evasion rate totals a single-digit figure. Moreover, it is illustrative to note the compliance shown by more similar economies such as Portugal or South Africa, where evasion does not exceed 15%, in order to understand the challenges our tax administration is facing in this area.

Table N° 7
Net VAT Evasion Rate
Year 1993 – Figures In Percentage

Country	Net VAT Evasion Rate
New Zealand	5.1
Sweden	5.4
Israel	7.8
Portugal	14.0
South Africa	14.6
Chile (1999)	**18.3**
Uruguay	29.7
Argentina	31.5
Honduras	35.4
Colombia	35.8
Hungary	36.3
Mexico	37.1
Ecuador	38.2
Philippines	40.8
Bolivia	43.9
Guatemala	52.5
Peru	68.2

Source: "Measurement of VAT Tax Compliance and Analysis of Key Factors", C. Silvani and J. Brondolo, IMF-CIAT-1993.

- Reduction of Evasion in the First Category Income Tax

With respect to the First Category income tax, there have also been significant reductions in the levels of evasion[15]. In 1990, the measurements indicate an evasion rate for this tax of nearly 50%. That figure in 1997 (last year available for that measurement) reached a level of 41.7%. We must bear in mind that this result has been achieved in a context of a hike in the tax rate (beginning in 1991 it went to 15% from 10%).

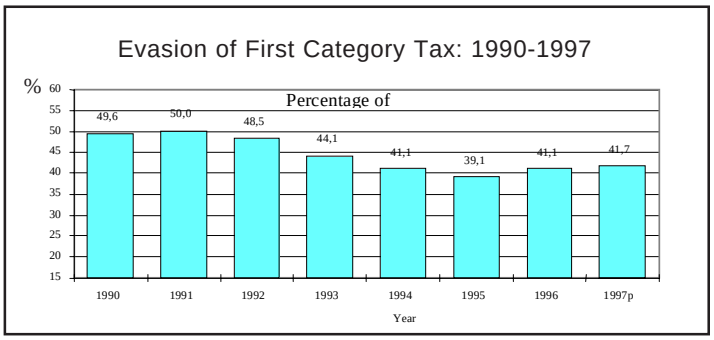
[15] *See note 15*

Table N° 8
First Category Tax Evasion

Year	Amount of Evasion [Mill.$sep99]	Amount of Evasion [Mill.US$sep99]	Rate of Evasion [%]
1990(1)	557,962	1,064	49.6
1991	569,584	1,086	50.0
1992	612,411	1,167	48.5
1993	511,644	975	44.1
1994	543,153	1,035	41.1
1995	584,778	1,115	39.1
1996	611,930	1,167	41.1
1997(2)	659,011	1,256	41.7

Source: Department of Studies - SII, based on information from the Central Bank.

Notes:
1 In 1990, the First Category tax rate was equal to 10% on withdrawn base. Beginning next year, it was changed to 15% and was applied to earned income. In order to estimate the evasion amount, an 18% rate for collections and earned base has been used.
2 Provisional figures.



It is not possible to obtain an independent temporary series for evasion for the remaining taxes on income. However, It is reasonable to suppose that for example the evasion of the Complementary Global Tax should show a similar trend to that experienced by the First Category tax rate. It is a matter of consistency that the preliminary returns of companies be associated with preliminary returns of company owners.

- Generation of Additional Resources Resulting from Reduced Evasion

The reduction of evasion levels of both the VAT and Income Taxes has the immediate effect of improving the level of collections. If we only take into consideration the significance of reduced evasion of VAT-First Category aggregate, we reach the conclusion that in 1999 over US$ 1.000 million in additional revenues were collected compared with 1990, because the evasion rate was reduced between 1990 and 1999.

Table N° 9
Additional Collections Every Year
Resulting from Reduced Evasion Compared with 1990

Year	In VAT [Mill.US$sep99]	In First Category [Mill.US$sep99]	In Both Taxes [Mill.US$sep99]
1991	128	-9(1)	119
1992	345	27	372
1993	621	124	745
1994	576	218	794
1995	578	307	885
1996	629	247	875
1997	684	242	926
1998	541	191(2)	732
1999	767	271(2)	1,038

Source: Department of Studies - SII, based on information From the Central Bank.

Notes:

1 This downward trend is explained by the increase of the evasion rate in 1991 compared with 1990.

2 No estimates are available for the evasion rate for this tax in 1998 and 1999. For the figures from those years, it is believed that the rate reflecting a lower VAT evasion in 1997 is maintained.

Taking into account total additional collections as a result of the reduction in the level of VAT-First Category aggregate evasion, a total of approximately US$ 6,400 million for the decade was estimated.

According to a study prepared by Engel, Galetovic and Raddatz in 1998[16] the larger collections in 1990 and 1996 are 40% explained by reduced evasion, 24% by legal changes and 36% by the growth of the economy.

4. FUTURE PERSPECTIVES OF THE STRUGGLE AGAINST TAX EVASION IN CHILE

4.1 The Diagnosis

At the outset of the year 2000, upon assessing the work done by the SII during the past decade and looking to the perspectives of future development, it was concluded that the efforts to increase collections allowed a considerable reduction in the overall tax evasion rate. Such rate was brought down to approximately 24%, which in the last few years has become stagnant. Without ignoring the success entailed by a six-point reduction in the tax evasion rate in the 1990s, it can still be deemed large compared with this same indicator in countries with good tax compliance. This paves the way for a continued effort to increase collections, tackling tax evasion in a more decisive manner.

However, given that the 1990s was a period of large economic growth in the country and consequently an increase in the number of taxpayers and their activities, it seemed rather difficult to continue to increase collections without a significant increase in resources and also new powers for the SII. During this period of time the Tax Administration obtained the successful result it had thanks to unchanged tax legislation and principles as well as a profound internal modernization process, which resulted in a significant increase in resource productivity.

The scanty human resources for carrying out examination work[17] limited the administration's ability to continue increasing collections. The qualification and professional characteristics of the staff now had to meet the most demanding standards of any preceding period,

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[16] *Report "Effects of the Action of the Internal Revenue Service on VAT and Income Tax Collection". Applied Economics Center. Department of Industrial Engineering, University of Chile.*

[17] *Shortage of human resources in the areas of collection and recovery were also detected, functions under the responsibility of the Treasurer General's Office.*

because under the current scenarios (lower level of evasion) one could anticipate examination would be more complex and specialized.

On the other hand, the gradual and persistent incorporation of computer and communication technology with taxpayers –in particular the Internet– to support massive examination and taxpayer payment control, made it necessary to reorganize institutional relations between the Services. This was done to standardize examination duties and tax payments, so as to have a comprehensive, timely and up-to-date view of the situation of every taxpayer.

All of these elements converged so that the new government that assumed office in the year 2000, the third coalition government to come to power in the 1990s, included in its program getting new sources of resources by reducing evasion. The purpose of this was to fund new increases in social spending. This was deemed as the preferred alternative over having to pass a new tax reform that would simplify the tax structure, impacting for instance on the rates, the tax base or both.

Thus, following the decision to advance in this direction, it was put to work by easing some limitations that existed, that is, granting the Tax Administration the necessary resources and powers. In addition, some aspects of the tax structure that undermined the justice and equity of the system were corrected. To that end, the government prepared a draft bill aimed at establishing legal standards to fight tax evasion and avoidance[18], which it submitted to the Parliament for discussion and approval[19].

[18] *In the discussions preceding the drafting of the bill, it was deemed necessary to correct certain legal provisions enabling taxpayers to appeal to the letter of the law to avoid payment or significant reduce their taxes. This generated inequity among taxpayers and large reductions in state treasury revenues.*

[19] *As of the writing of this paper, January of 2001, the draft bill was already approved by the Chamber of Deputies and is still pending approval in the Senate.*

4.2 Draft Bill that Sets Standards for the Struggle Against Tax Evasion and Avoidance for the 2001-2005 Period

In August of the year 2000, the government sent a draft bill to the Parliament, in which President Ricardo Lagos stated:

> *"The draft bill has three fundamental objectives: a) strengthening the capacity of examination and recovery of taxes by entities comprising the Tax Administration; b) introducing modifications in the legislation designed to close sources of tax evasion and avoidance, and c) modernizing and promoting a greater efficiency in Tax Administration entities".*

- Increase in Staff and SII powers

The project includes the *gradual incorporation of 539 new officials into the SII*, for the 2001-2004 period. Such an increase is equal to a 17.8% hike in SII staff. The new officials will be devoted to:

a) New plans of examination and/or strengthening existing ones (507), including the following:

- Tax audits to mid-sized and large companies;
- Increase of prevention and examination presence;
- Deepening of the scope and effect of the so-called income and VAT operations;
- Investigation of tax crimes and the falsification of invoices;
- Foreign exchange control of VAT taxpayer.

b) Increasing taxpayer service functions (25) clarifying in this regard the ambiguities that presently exist between the Treasurer's Office and the SII, which force the taxpayer –concerning similar issues– to move back and forth between both services.

- Unification of taxpayer service in one single institution (one-stop window);
- The SII, the only way to process refund requests.

c) Appoint more lawyers in the False Invoices' Attorney's Office (7), internal entity devoted to persecuting criminal responsibilities of individuals who engage in third party tax fraud, although in many cases they are not even taxpayers

Regarding the powers for the SII, the initiative includes modifications to the Tax Code:

a) *SII access to bank information on taxpayer's debts*. For these purposes bank secrecy will not be in effect, as it has up to now, with the only exception of the information with credit cards.

b) *Repeal of Law 18.320 (Plug Law),* law that to encourage the modernization of taxpayers with irregularities in VAT payment, limited the SII possibility of verifying back more than two years. With the repeal of this law, the periods of VAT that can be investigated are matched to those of other taxes, such as the Income Tax.

c) *Immediate penalties for those who fail to attend SII notifications and summons*, without awaiting a justification. This is done to reduce the high percentage of taxpayers who fail to show up when summoned.

d) *Increase of penalties for nonpayment of taxes detected in examination of surcharge, transfer or withholding taxes,* in order to help bring an end to these forms of undue appropriation of taxes paid by third parties and not made to the state treasury.

e) New penalties related to the falsification of tax documents, *to include individuals other than the taxpayer who use these documents and participate or promote the commission of those crimes.*

f) *Term for the statute of limitation of criminal actions,* which enables authorities to clarify an ambiguous situation with the terms, when the Director by the power vested in him refuses to file charges, limiting himself to seeking a monetary action.

g) *Safeguard measures of VAT payment in invoices granted by irregular taxpayers or in lost invoices,* allowing the buyer in these cases to generate purchase invoices.

h) *Strengthening and expediting recovery*, by giving the Treasurer's Office more resources –incentive by results system for officials– and powers to facilitate recovery and guarantee the payment of debts in the cases claim processes are started.

- Measures to improve efficiency

a) *Empower the SII to define the media whereby returns, forms and data files as well as the payment of taxes will be received.* The purpose of this modification is to facilitate an increase in the number of tax returns –and also of payments– through the Internet, in some cases even forcing certain taxpayers, with the ensuing advantages for the SII and the very taxpayer.

b) *Empower the Treasurer's Office to make refunds to the checking accounts of taxpayers who have those,* making it mandatory in the aforementioned cases to prevent the use of and mail problems for these purposes.

c) *Electronic payment of tax refunds via bank accounts,* making it mandatory provided that the taxpayer has such accounts.

d) Delimitation of (tax) functions between the SII and the Treasurer's Office, concentrating on the SII the relationship with the taxpayer regarding internal taxes and the resolution and processing of requests such as refunds and debt pardons (basing policy on those aspects, which the Treasurer's Office must mandatorily apply)

e) *Promotion of tax compliance with tax obligations and the one-stop window for the taxpayer.* This reinforces the concept that the SII is the appropriate entity for handling taxpayer internal taxes, including information to the taxpayer about his tax situation at all times, and asking him to pay his outstanding obligations.

- Justice and equity

The purpose here is to benefit taxpayers by favoring tax compliance. Among the proposed changes are:

a) Establish the adjustability of refunds similar to tax refunds, erroneously received by the state treasury.

b) *Expansion of the refund term* to three years, *thereby benefiting those who have made excess payments.*

c) *Power not to impose fines for minor offenses and where the state treasure has not been affected.* Penalties are imposed for more serious offenses that in fact result in damages to the state treasury.

d) *Reducing from 50% to 30% the additional tax on luxury goods, such as* jewels, fine leathers, mobile homes, weapons for hunting, and various other items.

- Tax Improvement

Many of the proposals listed below are designed to put an end to situations of tax elusion, making the tax system more equitable and, therefore, more widely accepted.

a) *Restriction of the systems of presumed income,* especially in such areas as mining and passenger transportation. Many mid-sized taxpayers, currently subject to these systems, would pay taxes in accordance with their real income.

b) *Apply the normal depreciation for the purposes of the Additional or Complementary Global Tax*, bringing an end to a situation that enables authorities to defer the payment of taxes for company partners or owners, because they can withdraw the financial profits without having to pay their personal taxes (additional or complementary global)

c) *Presume uniformity in the subdivision and sale of agricultural real estate,* so that in the cases of lot division for instance capital gains are subject to taxation, as in the case of urban land lots.

d) *Repeal in a definite manner credit to contributions, excepting agricultural real estate.* Presently, a temporary provision is in effect –will be in effect until December 31, 2001– to prevent the use of the Territorial Tax of nonagricultural real estate as credit against the First Category tax. Such measure sought to correct the existing unjustified integration between First Category Taxes and the Territorial Tax, which by their diverse nature and different final use should not be integrated from the economic standpoint. Contributions are rather a payment for municipal services that should not be deemed a tax. Consequently, it is proposed that the temporary measure be instituted in a permanent manner. Nonetheless, this measure does not affect farmers and in general those exploiting real estate.

e) *The utilization of losses in a business reorganization involving simultaneously the change of ownership and change of line of business will no longer be accepted.* This will bring an end to the purchase of companies with accumulated losses for the purpose of canceling profits in companies of any nature, thereby reducing or postponing the payment of taxes among the latter.

f) Capital gains obtained by institutional nonresident investors are exempt from the income tax, along with mutual and pension funds, in shares of corporations whose shares are traded in the stock exchange.

g) Apply the VAT on the sale of assets regardless of the term elapsed between the acquisition and purchase. This will prevent the purchase of assets by companies –not necessary to generate income–, which will be transferred, to their owners, employees and even third parties, without assessing the VAT, using the purchase VAT as a credit.

h) Condition the refund of the remaining VAT in cases where it accumulates from purchases, maintaining an activity that indefinitely will not generate debits, because such activities are not taxed with this tax.

i) Restrict access to the reduced 4% rate in case of interest remittances abroad and establish sub capitalization norms, thereby preventing foreign investment from being made with credits [20] at artificial rates –normally from related companies. This disguises the withdrawal of profits as interest, with the ensuing reduced payment of taxes in the country.

[20] *The legislation concerning foreign investors contemplates in these cases a single 4% rate on paid interest.*

4.3 Expected Results of the Plan for the Struggle Against Tax Evasion

- Sufficiency of assigned resources:

Table N° 10, which is shown below, depicts a study conducted in January of the year 2000 by a mission of French experts, which compared the resources of different tax administrations from OECD member countries with those of Chile. In order to make the comparisons consistent, tax administrations included such functions as examination, collection and recovery of internal taxes. Thus, in the case of Chile, experts included the SII and the section of the Treasurer's Office assigned to the collection and recovery of internal taxes.

The conclusion they reached is that Chile showed an extraordinarily low coverage level, because there were 4,051 inhabitants per every official. In countries with better performance, this figure was systematically in standards of less than one thousand inhabitants per official, except in the United States, where it does not exceed 2,700 inhabitants per official. With respect to the cost of the Tax Administration, the analysis produced similar results, because in Chile a 0.12% is assigned while the average for the countries that were included reached 0.27%.

In order to observe the consequences that earmarking more resources for the struggle against tax evasion law would have on the Tax Administration, the situation projected following the application of the regime of the *Plan for the Struggle Against Tax Evasion* has been included in the same table N° 10. This demonstrates that despite the fact this represents a significant increase of resources, Chile is still below the standards of developed countries that have been most successful in the area of compliance. Specifically, it has been estimated that the cost as a GDP fraction would increase to 0.15%, while coverage would exceed 3,500 inhabits per official.

Table N° 10
Indicators of Resources of the Tax Administration[1]

Country	Complete Cost/GDP [%]	Number of Inhabitants by Official
Germany	NA	603
The Netherlands	0.44	665
Italy	0.39	960
England	0.32	703
France	0.30	738
Sweden	0.29	783
Ireland	0.28	610
Canada	0.25	879
Spain	0.16	650
Chile[2]	**0.15**	**3,536**
Chile (1999)	**0.12**	**4,051**
EEUU	0.10	2,657
Average[3]	**0.27**	**1,270**

Source: "Comparative Analysis of Tax Administrations", document prepared by the General Taxation Directorate of France, 1999.

1 Includes internal tax examination and collection entities.
2 Includes the operation of the Plan for the Struggle Against Tax Evasion.
3 Includes "Chile (1999)".

- Result commitment and its effect on the tax evasion rate:

With regard to the yields, the project is based on a gradual increase of collections over a five-year period of time, with collection increasing by approximately 860 million dollars annually by the year 2005[21] . Of this amount, 592 million would come from the examination effort, 182 million from the diverse modifications to tax legislation (elimination of exemptions, tax avoidance) and 86 million from improved recovery of bad debts.

[21] *Said amount does not include increases in collection resulting from the expected GDP growth, which would occur regardless of the Plan, because such increases would not be the product of the action of the Tax Administration.*

The incorporation of new resources is also gradual, especially human resources, which together with the necessary physical resources for their performance, would have a cost by the year 2005 of approximately $20 million for the SII and 3.9 million for the Treasurer's Office.

The result of this additional collection effort that would be achieved with the proposed legal modifications, would be equal to reducing the total evasion rate of the economy from 23.9% to approximately 20%, as shown in the table below. It should be pointed out that total tax evasion was reduced from a rate close to 33% in the early 1990s to 24% presently.

Table N° 11
Total Evasion: Years 1990, 1997 and 2005 Projected[1]

Year	Amount of Evasion [Mill.$sep99]	Amount of Evasion [Mill.US$sep99]	Rate of Evasion [%]
1990([2])	1,706,949	3,254	33.1
1997	1,986,722	3,787	23.9
2000 without PLCE[(3)]	2,922,747	5,572	23.9
2005 with PLCE	2,445,814	4,733	20.3

Source: Department of Studies - SII, based on the yields of the Plan for the Struggle Against Tax Evasion (PLCE).

1 The projection considers a growth of theoretical collection equal to the GDP growth. Growth figures of 3.4% for 1998, -1.1% for 1999, 5% for 2000 and 6.5% for the following years are employed.

2 No independent estimate for total evasion for 1990 is available. This figure was estimated assuming the same behavior of tax evasion displayed by the VAT-First Category aggregate between 1997 and 1990.

3 It is believed that should the PLCE not be implemented, the 1997 tax evasion level will remain.

We must bear in mind that if this plan is not executed, and conservatively speaking the current level of tax evasion is maintained into 2005, tax evasion for that year only as a result of economic growth would exceed US$ 5,500 million. This provides a dimension of the opportunity cost involved in the plan.

4.4 Methodology Employed in the Study of the Project for the Struggle Against Tax Evasion

As indicated previously, this project will be the main source of financing of the new government's social program. Bigger collections to the tune of US$810 approximately are expected, US$678 of which would the product of reduced evasion and expediting recovery efforts. Evidently, a task of utmost importance, which took place prior to the submission of the project, was developing the methodologies that would enable authorities to estimate the bigger collections associated with increases in examination resources. This would give the government the assurance that this tax evasion reduction goal can indeed be achieved.

With this purpose a model was drafted for estimating larger collections resulting from the proposed measures, involving increased examination. This methodology established a universe of "potential actions", similar to what is referred to in private evaluations as potential market. These are designed to have a degree of participation or "coverage," which will increase gradually through an increase of human resources –auditors, auditing professionals and technicians– to conduct examination work. In addition, the direct yield of every examination plan was determined and the indirect yield of every examination action was estimated to be five times the direct yield. In this manner, new resources were assigned to the most profitable examination plans, estimating collection as the yield per action times the resources assigned to each plan.

The model included aspects pertaining to the individual yield of every action to reflect, on one hand, the effect that economic growth has on the income of individuals and company profits on collection and, on the other hand, to consider the decreasing yield when the level of participation of coverage is declining.

Additionally, the costs associated to the proposed measures were broached. An important detail in determining these costs was specifying the increases in staff and resources from these measures, in each of the echelons and for every year the study includes.

On the other hand, and as alternate method, the results of a study with which the SII tasked a group of academicians from the University

of Chile were used[22]. This study estimates, by way of econometric methods, the existing relationship between tax collection and the variables associated to the SII action. The result indicates that per every additional dollar assigned to the SII budget in 1998, VAT collection that year would have been 26 dollars higher. Consequently, every additional dollar assigned to the SII budget, would have generated a first category tax collection of 15 dollars. Applying those relationships to the larger resources contemplated in the draft bill, a yield similar to that attained using the previous methodology is obtained.

4.5 Current State of the Project for the Struggle Against Tax Evasion

As of the writing of this report, all efforts of authorities from Chile's Ministry of Finance were geared toward the approval of a draft bill for the struggle against tax evasion, which, as has been said, basically increases resources and powers of the Tax Administration. It has not been official said whether the Administration is ready to embark on other initiatives that may impact on new changes in the Chilean tax legislation.

Meanwhile, the discussion in the Parliament of the draft bill for the struggle against tax evasion has had repercussions on public opinion and influential taxpayer sectors, such as business associations. This generated a broader discussion in which different views have been aired regarding the convenience of addressing such issues as the simplification of the tax structure, low income tax marginal rates for individuals and others.

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[22] *See note 17*

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Case study:

TOPIC 1.1

TAX EVASION, TAX POLICY AND THE MARKET ECONOMY

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CONTENT: A. The Accomplishments of the Struggle Against "Traditional" Tax Evasion Gave the States Some Control of Their Fiscal Policy.- 1. Control of "traditional" tax fraud…- 2. …That gives the State certain control over their fiscal policy.- B. But in the Context of a Globalized Economy, the Growing Mobility of Taxation Generates New Risks of Evasion that Affect the Autonomy of Fiscal Policies.- 1. A globalized economy, source of new opportunities for tax evasion.- 2. Fiscal policies view their autonomy threatened.- C. This Situation Requires World (or Regional) Responses in Keeping with the Commercial Flows...- 1. Regaining control over information by working together.- 2. Minimum rules of the game.

In an interview granted to a great Anglo-Saxon weekly, the president of the Supreme Court of Sweden declared: "I like to pay taxes. When I pay taxes, I am buying civilization." If all our fellow citizens had this same conception about taxes, the work of our administrations would undoubtedly be simpler. However, we must admit that our societies have in their ranks individuals for whom there are a strong temptation to take advantage of public spending, without making their contribution. Tax evasion is a reality that must be taken into consideration.

It also poses a threat to the good functioning of our economies, by adversely affecting competition, and to the election of fiscal policies from our States. It questions the primary function of taxes, namely the collection of funds that are necessary to finance public spending.

Thus, fiscal policy and tax evasion are very closely related: the need to guarantee public revenues forces the States to establish the tax on a tax base they can control. If a State can determine and examine only a small part of the economic flows existing in its territory, its capacity to maneuver for the definition of its fiscal policy will be limited because it will be forced to assess the tax base based exclusively on those elements. On the contrary, a state that had full knowledge and absolute control over the economic transactions in its territory would have total liberty to select its fiscal policy. But a State of this kind would have to necessarily be a totalitarian State; in the "market democracies" that we all know, the reality is somewhere in between.

The threats posed by tax evasion on the ability of the States to control their fiscal policy and on the market economy have acquired greater dimension in the context of the globalized economy. Some aspects of tax crime today appear to have been placed under control worldwide, or are in the process of being controlled, together with the capacity of the States to handle their fiscal policy. The emergence of a globalized market economy and technological development strengthened the mobility of taxation. They created new sources of tax evasion that are more difficult to fight within the context of our internal legislation. In the face of the globalization of commercial exchange and the progressive disappearance of borders, only coordinated fiscal policies can return to States the control over their fiscal policy.

A. THE ACCOMPLISHMENTS OF THE STRUGGLE AGAINST "TRADITIONAL" TAX EVASION GAVE THE STATES SOME CONTROL OF THEIR FISCAL POLICY

1. Control of "Traditional" Tax Fraud...

Tax fraud is without doubt as old as the state treasury itself. Tax administrations always attempted to reduce this phenomenon by establishing, in the framework of their territory, certain management practices, an examination organization and a legislation that penalizes tax fraud. This fraud had a very marked territorial nature: on one hand, the national legislation favored, because of its peculiarities, ways of defrauding the state treasury that shows a

relative specificity from one country to the other. On the other hand, taxation in itself had very little mobility. In this manner, trade and international financial transactions entailed a limited amount of companies, which also had to take into account tariff regulations and foreign exchange controls.

This fraud, which I would term “traditional” for lack of a better term, is far from having disappeared. But we can state that today, for the most part, it is under control at least in more developed countries.

First, because the efforts of the tax administrations to guarantee voluntary compliance with tax obligations by taxpayers, together with an active policy of information for both individuals and companies, had positive effects on the fiscal behavior of taxpayers. It brought compliance with tax obligations to levels that from now on make noncompliance rather marginal.

Subsequently, the effectiveness of tax control has improved significantly thanks to the use of sources of information tax administrations have, in the framework of their internal legislation. This was also made possible by the growth of databases for the exchange of information and tools that allow the optimization of their use, especially those based on the analysis of risks. Although permanent monitoring continues to be necessary, the progress made in the control media has mechanically reduced the risks of fraud.

2. ... That Gives the State Certain Control Over Their Fiscal Policy

With the control of fraud risks and the progress made in the capacity of our administrations to promote tax awareness, the macroeconomic impact of tax evasion seems to be almost negligible, at least for the taxes whose tax base has little mobility.

It cannot be denied that tax evasion or tax fraud deprives the States of budget revenues – the amount of taxes dodged disclosed by examination operations serves to remind us of this. It is true that the risk of tax evasion could historically influenced the big equilibrium of the fiscal policy of States, making them prioritize

taxes whose tax base can be easily controlled. The long-term evolution of tax systems demonstrates that States are capable of easing the pressure the threat of tax evasion exerts on tax policy options.

A specific example allows me to illustrate such evolution: France in the past introduced a tax called “tax on doors and windows.” This tax simply consisted of taxing the owner of a home in accordance with the amount of doors and windows it had. Although it might seem a bit rudimentary at present, this tax had the enormous advantage of being easy to control and generating little propensity toward evasion. It led many homeowners back then to limit the amount of openings in their homes. There are still in France evidence of that experience in some homes. This reflected the capacity of the State in those days to handle the information related to revenues and the assets of its taxpayers. In addition, the tax enacted by the Old Regime, tax on salt consumption, attempted to reflect the overall consumption of homes in a time when the State was not in a position to learn first-hand the consumption of products.

If our modern States today can establish an income tax estimated in accordance with complex and rectified rules, taking into account numerous tax deduction and reductions, if it can levy a common tax on consumption in households, it is because States have acquired the power to ensure that the data on which such taxes are based are sufficiently comprehensive. This is accomplished through sophisticated examination methods or large-scale exchange of information. In other words, tax evasion, taxation that falls outside of the administration’s knowledge or control, is kept at marginal levels.

B. BUT IN THE CONTEXT OF A GLOBALIZED ECONOMY, THE GROWING MOBILITY OF TAXATION GENERATES NEW RISKS OF EVASION THAT AFFECT THE AUTONOMY OF FISCAL POLICIES

The examination of the national territory that States were able to organize seems to work only for the least mobile tax base. The earnings of a national businessman, the properties one may possess or the products consumed within the national territory are well

examined by the States. Meanwhile, their capacity to control mobile income is more limited. Mobile income must be construed as the income or assets of residents who are not subject to the delimitation of international borders and, therefore, the space where States must exercise their jurisdiction and its power to control information related to economic flows. This is the case, for instance, of foreign-earned income from accounts abroad, or even income or assets received or owned in the national territory, but through juridical structures that are not registered in the national territory.

1. A Globalized Economy, Source of New Opportunities for Tax Evasion

Now, the recent development of our economies has gradually increased the mobility of properties and capitals and fiscal policies of developed countries presently run the risk of a destabilization from the new forms of tax evasion. These forms of tax evasion are supported by the mechanization of transactions and the internationalization of exchange, both of which are facilitated by the opening of the markets at the regional or international level.

While markets were coming together, we saw how international tax evasion diversified and intensified. Some companies were able to take advantage of the disparity between national legislation and the difficulties generated by the development of mobile activities beyond borders for strongly “territorialized” tax administrations. Of course, the States reacted and the 1980s saw the emergence in national legislation of legal provisions against abuses. But those mechanisms were limited by the development of mobile activities and the emergence of new forms of trade, for which the concept of fiscal territory appears inappropriate, if not obsolete, with respect to the conditions determining its development. These new conditions are capable of depriving States of a growing part of its fiscal revenues, as the right to impose a tax always implies a point of territorial impact. Now, such right tends to decrease as more and more automated exchanges are carried out, each time more difficult to track down in accordance with the criteria that served as basis for the traditional right of a State to claim jurisdiction over a transaction taking place in its jurisdiction. There is then the risk for the establishment of a fiscal “no man’s land” where no State might

make use of the right to impose a tax or the ability to do so. This "gray" zone runs the risk of growing with the development of the service sector of the economy and of mobile activities, principally financial activities.

2. Fiscal Policies View Their Autonomy Threatened

The first consequence of this situation is a progressive loss of autonomy of national fiscal policies. While States have increasingly controlled, through multi-secular efforts, the information related to income and assets owned in its territory and with it the power to establish a greater freedom in its fiscal regime, the growing international mobility of taxation today questions such an accomplishment.

In an open world, a company's selection of a location for its activities necessarily takes into account the weight of fiscal pressure, although such element only constitutes a one factor among many for the decision of opening there. Each State, from now on, must weigh the risks of displacement that may be generated by a policy whose effect was increasing fiscal pressure on the most mobile categories of income or activities. Mobility today threatens the autonomy of fiscal policies because it forces States to take into account in its decisions the tax norms applied by neighboring countries. And this can be corroborated even more in the areas where the game of regional integration has progressively erected juridical obstacles in order to favor the mobility of assets and capitals.

Another element in this study of the potential sources of erosion in the field of taxation should not be ignored: I am talking about the concept of harmful tax competition.

Some States have deliberately bet on the mobility of assets and capitals to try to attract foreign investments by promoting incentive mechanisms for certain activities or concentrating in a specific region activities considered as "offshore" activities. They further tax competition and knowingly provide media to taxpayers so they can significantly reduce their tax contributions and even evade taxes, while taxpayers continue to benefit from the public services of their country of residence. We must bear in mind that this attitude comes from both so-called called "tax havens" and States that do

not consider themselves as such but divert from other countries flows of capitals and tax revenues. They do so by practicing an overbid with the establishment or derogatory tax provisions.

We must recognize it, the temptation for everyone to adhere to this way of thinking and later come out well is strong. But by doing it, everyone must be aware that we are collectively destroying our ability to determine freely the fiscal policy we would like to implement in our own territory.

C. THIS SITUATION REQUIRES WORLD (OR REGIONAL) RESPONSES IN KEEPING WITH THE COMMERCIAL FLOWS…

The internationalization of commercial exchange and the progressive appearance of an almost worldwide market economy constitute a powerful factor of unification of tax systems. This situation may lead to a harmonization of tax systems from below, forcing administrations to limit fiscal pressure on most mobile revenues or activities. The inability of States to control tax evasion seems to be greater than the states' will to tax mobile transactions.

At the risk of accepting a slow and irreversible erosion of their revenues, developed States today must react not in a disorganized manner and to deal with their short-term interests alone, but quantifying really the scope of these challenges. By their nature, these challenges go beyond the territory of states. Otherwise, developed States run the risk of placing the basic tax burden, by substitution and not for being unable to tax these activities or mobile entities, on least mobile (salaried workers) or most "visible" (activities whose territorial anchorage is more evident) elements.

If out of a desire for fiscal equality we do not want to admit this "defeat of taxation," only the implementation of coordinated tax policies may make us recover – by working together – the free election of our fiscal policies.

Two avenues may allow us to regain control over tax evasion: the exchange of information and the establishment of rules of the game that area acceptable to everyone.

1. Regaining Control Over Information by Working Together

The mobility of persons and capitals makes it increasingly necessary to have access to sources of information that the means of the national administrations, limited by the territorial framework of their competence, by themselves do not allow us to achieve.

Often times, the adequate focus of a fiscal situation implies the use of data in the possession of another State. In the struggle against tax fraud, States have from now on an obligation of solidarity and such solidarity is based on the exchange of useful information for the struggle against tax evasion and tax fraud. In this regard, banking secrecy, no matter how legitimate it may be, must make way to the need for cooperation among administrations that are facing a common threat. Within this same perspective, the obstacles for the exchange of information, whether technical or from restrictive national legislation, must be progressively resolved.

I would like to remind you in this regard that OECD countries have undertaken a notable effort. The aim is to bring States that chose to play the game of unfair tax competition into the game of the exchange of information. Those States chose to contribute actively to tax evasion regarding transactions, the receipts of which most countries need to finance public spending. France has played and continues to play an important role in these works that have already generated benefits, which everyone – OECD and non-OECD member countries — will ultimately utilize.

For those of us who chose the path of cooperation, it becomes necessary not only to intensify but also to expedite those exchanges. The purpose of this is to regain the capacity to react in the face of operators who take advantage of the inertia force of our administrations and the slowness in providing administrative assistance. In the meantime, we must take advantage of the new technologies to facilitate our exchanges and fight international tax fraud more effectively.

2. Minimum Rules of the Game

No matter how necessary it may be, the exchange of information only deals with symptoms without necessarily reaching the origin of the problem, namely the varied heterogeneity of our fiscal pressures.

In fact, this heterogeneity reflects the differences between the selected fiscal policies, and it is important to preserve this freedom of decision. It is precisely to defend such freedom, threatened by those who take advantage of our differences, that we must reach agreements on a minimum base of rules of the game that are acceptable to everyone. This effort must be launched at the regional level because it reflects before all an economic reality.

This is the decision that member States of the European Union expressed when taking the initiative of identifying their harmful tax regimes as well as their harmful tax practices, with the purpose of dismantling such regimes before January 1, 2003, or adapt them to eliminate their harmful characteristics.

With this initiative, the States of the European Union pursue a twofold objective: guaranteeing the equality of everyone in the face of taxation by distributing the fiscal burden in the more equitable manner; later establishing in the context of an open economy an appropriate framework for healthy competition between economic players.

Any of the aforementioned two objectives today requires a constructive attitude from the States at the international level. Ensuring everyone's equality in the face of taxation and everyone's participation in the collective spending implies fighting resolvedly against all forms of tax evasion

Now, in order to be effective, this struggle necessitates that we overcome national differences. In addition, the creation of an international framework that favors growth entails cooperation from all States so as to define the rules of competence between economic players, which is not undermined by the impact of taxation on their behavior. This is the path selected by the European Union but also by the OECD Tax Affairs Committee. The European Union seeks a progressive integration while the OECD Tax Affairs Committee pursues the establishment of common standards for all of the developed States.

These options are necessarily difficult, because they entail for States the loss of a part of their autonomy in devising their tax policies or rules. However, to some extent, it is an autonomy in appearance that is being sacrificed and that, for quite some time,

most mobile economic players overcame with their practice of tax evasion. Behind this apparent sacrifice there is, however, a real effort to regain, by working together, the control over our tax rules and provisions.

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Case study:

TOPIC 1.2

THE SOCIAL AND POLITICAL LEGITIMIZATION OF THE STRUGGLE AGAINST TAX EVASION

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CONTENT: Introduction.- 1. Society's Tax Awareness.- 2. Tax Legislation Adjustment and Complexity Level.- 3. Efficiency and Effectiveness of the Tax Administration.- 3.1. Efficiency and effectiveness in the application of the legislation.- 3.2. Efficiency and effectiveness in the Tax Authorities – Taxpayers Relationship.- 4. Recovery of Tax Credits.

INTRODUCTION

As society develops, the demands for health, education, security, entertainment etc., grow, and if more and better public services are demanded, evidently a greater cost is distributed among society.

However, if on the one hand a marked increase in public expenditure is registered, on the other grows the difficulty to find financing sources and the total inability of the States to acquire debts to finance these expenses.

In this manner, public expenditure financing has to take place by means of increasing collection, but in a balanced manner, in regards to the citizen's taxpaying capacity and if possible, without the creation of new taxes.

Developing countries, that is, emerging economies, attempt to modernize their economies and adopt a tax system compatible with the same. The ideal tax policy is one that collects whatever is indispensable to cover public costs and investments demanded by the society, through the contribution of all citizens, according to the taxpaying capacity.

Simple tax norms that reach a broad universe of taxpayers and skillful, and efficient tax administrations with effective norms are currently universal aspirations.

However, in the practice, the equal distribution of the tax burden to each taxpayer, according to the norms established, presents a series of difficulties, being tax evasion the main one. The saying goes: "The person who likes to pay taxes has not arrived yet".

Tax evasion practices constitute a severe blow in public finances, since not everybody pays, those who do comply with their obligations are overburden, in favor of part of the society that prospers at the expense of the public resources.

Tax evasion results from illegal behavior, whereby the taxpayer ceases to comply with tax laws. Illegal behavior is translated into an action or in an omission that, whether conscious or not, results in the suppression of the State's financial resources. In offenses against tax laws, the agent's intention is irrelevant, since as well as in offenses against the life of a person, the agent's intention should be evaluated when applying the sanction.

The government's budget is the society's political will instrument. In the same public policies are defined for an administration period and it distinguishes the source of the resources. Among them we have tax collection, which is the public financing source. The citizen is placed together with the tax collection estimate and the amount that shall be paid. The budget is a technical piece of public administration as well as a juridical element.

Behaviors that do not comply with budgetary programming, whether it is on the resource application side or the income collection side, are contrary to the will of the society and subject to ethical and legal sanctions.

Tax evasion

In spite of the democratic and ideal nature of taxes, its demand is an imposition and the difficulties to collect the same are historically well known. Taxpayer always reacts to the payment of taxes for different reasons. Thus, tax administrations must adopt policies directed to reach the following objectives:

1. SOCIETY'S TAX AWARENESS

Tax awareness is the result of tax education and it constitutes the adequate mechanism to form individuals conscious of the social role and of the amount of tax owed to society.

On the other hand, tax education cannot only be seen from the tax collection point of view, but on the side of the examination aspects of the government programs and the application of public resources as well.

This discernment emphasizes the individual's responsibility regarding the social group and prepares citizens for their active performance in a political society, making him/her a participant in the collection of government programs, in the examination of priority budget expenses and in the collection of estimated taxes.

As we can see it is fundamental that tax administrations, through its means or through agreements with other public and private organizations, develop permanent dissemination and tax education programs.

Brazil's experience

In 1996, Brazil signed the Technical Cooperation Agreement between the Union, the States and Federal District, seeking to implement a permanent national tax discernment implementation program to be carried out in the Federation's units.

Among the tax modernization projects we have the permanent national program on tax education to be developed by the States of the Federation and by the Federal District, seeking to promote, coordinate and provide follow-up for the actions necessary to prepare and implement a permanent tax discernment program with the purpose of awakening full exercise on behalf of citizens in society.

This program, called “National Program on Tax Education (PNEF, in Portuguese)”, coordinated by the Fiscal Administration School (ESAF, in Portuguese), focuses, in addition, to citizen awareness in the need and social function of paying taxes, also focuses in their awakening towards aspects pertaining to the administration of public resources.

Upon involving citizens in the follow-up of quality and adjustment of public income and expenditure, installs social control on the performance of public administrators and in the social results obtained. This complicity of the citizen with the State allows transparency in the public budget and harmonizes the citizen / taxpayer and State / collection relationship. This is the social coexistence scope sought to be achieved.

The perfection of the relationship between the State and the citizens, awareness on the tax’s social function and assuredness that public expenditure and investments are appropriate and that the resources taken from society are properly managed, and constitute indispensable elements to form enlightened, participative and goodwill taxpaying citizens, this certainly leads to reduce evasion and to increase tax collection.

The PNEF is being developed in 5 modules:

Module I – Primary Education Establishments

a) **Scope** - Students, professors and primary education professionals of the public and private network.

b) **Objectives** - Implementation in primary education establishments of activities directed to Tax Education and, more specifically towards the inclusion, as collateral topic, in the nucleus “Citizens and Ethics” of contents directly linked to tax aspects and the perception of the application of public resources.

Module II – Middle Education Establishments

a) **Scope** - Students, professors and middle education professionals of the public and private network.

b) **Objectives**

- Implementation of Tax Education in middle education, as a topic to be treated collaterally in traditional academic program classes.
- Create awareness in teenagers regarding the need of their participation in the obtainment and management of public resources..
- Provide students with the necessary means to achieve the follow-up and evaluation of the application of public resources.

Module III – Education, Treasury, Finance or Tax Secretariats and others

a) **Scope** - Treasury, Finances or Tax Secretariats, Education Secretariats and others, of States and Municipalities.

b) **Objectives**

- To promote Tax Education in the internal customers of the Treasury Secretariat, Education Secretariat and others, by creating conditions the conditions so that they may exercise their citizen rights and, as State representatives, they may be able to disseminate their knowledge and techniques that allow that exercise for society;
- To promote teachers' education, this shall facilitate the participation process, acquire knowledge, values, aptitudes and critical awareness of society, in tax management;
- To support the preparation and dissemination of education materials seeking to provide instructions regarding Tax Education in school syllabuses.

Module IV – Public and Private Universities

a) **Scope** - Students, professors and professionals of public and private universities.

b) **Objectives**

- To promote discussions regarding Tax Education among university students;
- To achieve the goal that young people should not have any doubts regarding the importance of their participation, in the obtainment and management of public resources, as a citizen – student or as a professional.

Module V – Society in General

a) **Scope** - Brazilian Society.

b) **Objectives**

- To develop in Brazilian society participation and critical awareness of citizen, tax and public finances issues.
- To create awareness in the population regarding the importance of providing follow-up in the administration process of public resources, in what pertains to tax collection as well as in public expenditure.

Results obtained at present

Data presented hereinafter refer to the implementation of phased projects in Module I – Fundamental Education and Module II – Middle Education.

Results Obtained	1998	1999	2000
Number of students trained	371,162	545,502	871,727
Number of schools included	1,841	2,139	2,450
Number of teachers trained	10,426	12,198	13,141
Number of municipalities involved	191	256	313

2. TAX LEGISLATION ADJUSTMENT AND COMPLEXITY LEVEL

Tax legislation by nature, presents characteristics that are not well known by most of the population. It is mentioned, as in the case of the definition of the generating fact of the Income Tax, which includes from a simple fact (salary remunerated work) up to a complex fact (variable income obtained in the capital markets).

The more complex the tax legislation, greater the possibilities of tax avoidance and evasion.

Tax avoidance is the use of faults or gaps contained in the legal provision to produce tax economy. This often occurs when the law allows different interpretations among the tax law operators, with the purpose of fleeing from the tax generating fact. Avoidance is so complex, that often it is the purpose of discrepancies in the Tax Administration, among external consultants and even in the core of the judicial power.

At the same time, tax evasion practices also maintain a relation with the complexity level of the tax norms that, in general, establish difficult and onerous accessory obligations for the taxpayer.

Simplification is not less important than the drafting of standards, which neither is nor periodically modified. It is fundamental for tax legislation to have a lasting nature, since frequent changes in the standards do not allow its comprehension to settled in society. Constant changes in laws create difficulties, for the taxpayer as well as from the tax administration.

In this regard, to attempt to simplify provisions without loosing sight of the fact that the control of the tax base is a challenge for Tax Administrations. It must be understood that such simplification not only in regards to the standard, but also, regarding the proceedings necessary for taxpayers to comply with their obligations. The use of new technologies, electronic returns and instruments such as the Internet, must be promoted.

There are legislations that operate as protective shields for infringing taxpayers. Such provisions, under the argument of protecting the individual's intimacy, end up allowing in many cases, the concealment of irregular facts and operations, which consequences may take place in the tax field and in the penal sphere.

Legal order restrictions that prevent or difficult the access of the Tax Administrations to information of tax interest, as well as those that favor the creation of tax havens, currently do not harmonize. Laws of such nature are adequate and cannot be admitted by a modern State, because they end up protecting the person that evades the payment of taxes, with serious losses for collective interests.

Unlimited and irresponsible access to citizen's privacy is not admitted. In any event, the Tax Administration must fully justify the need to obtain information that constitute tax evasion, as well as provide transparency to the process and fully defend the taxpayer under examination.

Brazil's experience

In Brazil, Federal Revenue Secretariat (SRF) has sought to simplify tax norms and procedures. Considerable advances have been achieved during the past years in the tax simplification and rationalization fields. We shall now see the main cases.

a) Establishment of the Integrated Tax and Contributions Payment System for Micro and Small Size Businesses /SIMPLES (in Portuguese).

SIMPLES is a simplified tax payment system, created to attend small businesses, the same has been in force since January 1st, 1997. The system consists in the unified payment of taxes and contributions, through a single rate applied to the business' gross income.

This single rate comprises the following taxes and contributions:

- IRPJ – Corporate Tax
- PIS – Social Integration Program Contribution
- COFINS – Social Security Financing Contribution
- CSLL – Social Contributions on Net Profits
- INSS – Social Security Contributions (employer's portion)
- IPI – Tax on Industrialized Products
- ICMS – Tax on the Circulation of Goods and Services (state tax), when it is established through agreement
- ISS – Tax on Services (municipal tax), when established through agreement.

For purposes of registration in the **SIMPLES** system, a Micro Business (ME, in Portuguese) is considered as a body corporate that generates, during the fiscal year, gross income equal or lower than R$120,000.00. A Small Size Business (EPP, in Portuguese)., is a body corporate that generates, during the fiscal year, gross income higher than R$120,000.00 and equal or lower to R$1,200,000.00

Legislation defined as gross income the product of the sale of goods and services in transactions registered by the company, the price of services rendered and the result in operations for other companies, excluding cancelled sales, and discounts granted.

Businesses that opt for SIMPLES, in addition to procedure simplification for tax collection, have their tax burden reduced pursuant to the rates defined:

· Childcare Centers, Pre-schools and Primary Education Establishments

Accrued Gross Income	**ME**
Up to R$ 60,000.00	4.5%
From R$ 60,000.01 up to R$ 90,000.00	6.0%
From R$ 90,000.01 up to R$ 120,000.00	7.5%
Accrued Gross Income	**EPP**
Up to R$ 240,000.00	8.1%
From R$ 240,000.01 up to R$ 360,000.00	8.7%
From R$ 360,000.01 up to R$ 480,000.00	9.3%
From R$ 480,000.01 up to R$ 600,000.00	9.9%
From R$ 600,000.01 up to R$ 720,000.00	10.5%
From R$ 720,000.01 up to R$ 840,000.00	11.1%
From R$ 840,000.01 up to R$ 960,000.00	11.7%
From R$ 950,000.01 up to R$ 1,080,000.00	12.3%
From R$ 1,080,000.01 up to R$ 1,200,000.00	12.9%

Whenever the State and/or Municipality wherein the ME or EPP is established would have adhered to SIMPLES, the percentages of the chart above shall be increased as determined in the agreement.

- Other activities

Accrued Gross Income	**ME IPI taxpayer**	**ME non IPI taxpayer**
Up to R$ 60,000.00	3.5%	3.0%
From R$ 60,000.01 up to 90,000.00	4.5%	4.0%
From R$ 90,000.01 up to 120,000.00	5.5%	5.0%

Accrued Gross Income	EPP IPI taxpayer	EPP non IPI taxpayer
From R$ 240,000.00	5.9%	5.4%
From R$ 240,000.01 up to 360,000.00	6.3%	5.8%
From R$ 360,000.01 up to 480,000.00	6.7%	6.2%
From R$ 480,000.01 up to 600,000.00	7.1%	6.5%
From R$ 600,000.01 up to 720,000.00	7.5%	7.0%
From R$ 720,000.01 up to 840,000.00	7.9%	7.4%
From R$ 840,000.01 up to 960,000.00	8.3$	7.8%

Whenever the State and/or Municipality wherein the ME or EPP is established would have adhered to SIMPLES, the percentages of the chart above shall be increased as determined in the agreement.

With the simplification adopted, a considerable number of businesses adhered to the system, providing the tax administration the knowledge and control of a significant number of small taxpayers, many of which were located in the informal economy.

Corporate Filers (Type)	Receitanet	Transdados	TOTAL
DIPJ Real Profits	205,447	936	206,383
DIPJ Estimated Profits	612,859	4,754	617,613
DIPJ Arbitrated Profits	1,718	14	1,732
DIPJ Real / Arbitrated Profits	44	0	44
DIPJ Estimated/Arbitrated Profits	360	13	373
DIPJ No Lien	49,758	1,027	50,785
DIPJ Exempted	186,737	4,020	190,757
PJ SIMPLES	**1,971,180**	**31,585**	**2,002,765**
PJ Inactive	1,249,875	25,879	1,275,754
Total Corporate	**4,233,093**	**68,228**	**4,301,321**

Regarding the 2000 fiscal year, 1999 fiscal year.

b) Tax substitution system practice

Certain economic sectors that register greater trends towards the practice of *tax evasion* and since they constitute productive chain matrixes turn into tax control objectives through tax substitution or through the adoption of a tax payment single-phase system in the productive chain.

Tax substitution consists in making the producing establishment or its equivalent to be responsible for the collection of taxes that have an incidence on the other productive phases up to consumption. In this situation, the industry collects, in its taxpaying nature, incident liens on its invoicing and in the capacity of responsible, taxes that have an incidence on the invoicing of the following phases (wholesale and/or retail).

In the automobile sector there are 2400 companies included in the tax substitution system.

In the *single-phase system,* the tax matrix is changed to encumber the producing establishment or to equal it, since it collects taxes in its taxpayer capacity, estimated by rates that cover the other phases of the process. This is the case of oil byproducts. Through this instrument, the wholesaler and/or retailer receive a tax reduction from the tax burden; in compensation thereto a cost increase occurs, the same corresponds to the tax paid by the refinery.

With this system legislation and procedures have been simplified, as well as the reduction of the universe of taxpayers to be examined. It is important to mention, that this system is not applied to all sectors and all taxes.

This is only feasible in sectors where there is a monopoly or an oligopoly in production and specifically in regards to taxes that have an incidence on invoicing (income).

c) Permanent legislation – Income Tax

Regarding the Income Tax, the federal tax legislation on corporations as well as individuals, remained the same during the past years, practically without any amendments. The last large amendment took place in 1977, with the enactment of Law No. 9,532, of November 14th, 1997.

It is important to mention that tax legislation is closely related to the country's economic stability. There were times when ample amendments took place in the legislation at the end of each year, as a result of high inflation rates or looking for an increase in collections. Such practice resulted in juridical instability and in the economic taxpayers' insecurity, it also meant great difficulties in the law enforcement and verification of tax compliance.

Economic dynamics, the creation of global markets, the evolution of international financial operations, virtual commerce, cannot be ignored. In this world of constant changes, the legislator must be keen in identifying the tax consequences of these transformations and if possible, to be able to anticipate the same. Therefore, it is natural that corrections as well as improvements be introduced.

d) Legislation regarding Bank Secrecy and Discredit of Juridical Business

Recently the National Congress approved two laws of fundamental importance to struggle against tax evasion in Brazil. These are Supplementary Laws Nos. 104 and 105, both of January 10, 2001.

Supplementary Law No. 104, of the year 2001, amended the National Tax Code, to prevent the Administrative Authority from considering juridical acts or businesses carried out for the purpose of concealing the tax generating event or the nature of the elements that constitute the tax obligation. In order to use this important instrument, it will still be necessary to observe procedures to be established in the ordinary law.

Supplementary Law No. 105, of the year 2001, allowed the Tax Administration access to financial registries performed through financial and similar institutions, of all taxpayers under examination procedures. Prior to such law, the tax administration was dependent on the Judicial Body's authorization, which could only be obtained on a case-by-case basis.

The approval of these provisions has been the result of two years of intense political discussion in the National Congress, which denotes the true social legitimization of the struggle against tax evasion.

The regulation of Supplementary Law No. 105, of the year 2001 deserves special attention, which by means of Decree No. 3.724 of January 10, 2001, ruled with great detail the request, access and use of banking information protected by secrecy by the Federal Revenue Secretariat and its agents.

The aforementioned Decree must safeguard the taxpayer's tax secrecy and allows full knowledge of the information request process; selects the tax administration authorities that may request banking information; clearly appoints the cases where the tax

administration may have access to the information mentioned; and details the fiscal and administrative steps and procedures that the tax administration and its agents may follow to obtain banking information.

Recently to emphasize the importance of banking information for the Federal Revenue Secretariat, until then kept under top secret, a survey was carried out recently that identified a relevant number of taxpayers with significant financial movement and who do not file income tax returns.

- Amount of individual taxpayers with financial movement above R$ 1,000,000.00 – 7,977 taxpayers.
- Amount of corporations with financial movement above R$ 5,000,000.00 – 2,453 taxpayers.

3. EFFICIENCY AND EFFECTIVENESS OF THE TAX ADMINISTRATION

Another important cause for tax evasion is the inefficiency and ineffectiveness of the tax administration, that is, the materialization of the tax system of a country. There is no efficient and effective tax system without a supporting tax administration.

Two tax administration's action lines are fundamental in the Treasury-Taxpayer relationship:

3.1. Efficiency and Effectiveness in the Law Application

When the tax administration shows signs of vulnerability, insecurity and flexibility not comprised in the juridical norms, the taxpayer feels stimulated to adopt tax-evading procedures.

In this manner, the knowledge of the taxpayer universe and its tax potentials, as well as agility in the actions to struggle tax behavior deviations, regardless of the economic or political representation of the taxpayer, results in a "demonstration effect" – inhibiting evasion. The offender, the infringing taxpayer cannot have the sensation of impunity or feel the discredit of the fiscal units.

Firmness and inflexibility in the struggle against evasion are not confused with arbitrary actions. Tax evasion must be fought under the tenor of juridical norms. Actions that surpass legality and lack of respect towards taxpayer's rights favor the disadvantage of tax officials and of the same institution.

3.2. Efficiency and Effectiveness in the Treasury – Taxpayer relationship

If on the one hand, the tax administration must be rigorous with the offending taxpayer, in compensation it must offer to the taxpayer – citizen all the conditions and powers to be able to properly comply with its tax obligations.

Without having to use a direct and firm hand regarding compliance with tax norms, the Tax Administrator must provide to the good taxpayer dignified treatment and be a legitimate economist in what pertains to social demands. Bureaucratic costs for the taxpayer should be reasonable for the sustain and control of the tax base.

Brazil's experience

In seeking to firmly combat tax evasion, in application of the legal acts, the Federal Revenue Secretariat since 1995 has introduced systems and provisions that determine criteria and guidelines in the selection of taxpayers for inspection, such as quality patterns in the execution of examination procedures.

a) SRF's examination system

Combat actions directed to struggle tax evasion practices, in the scope of the Federal Revenue Secretariat are under the General Coordination of the Examination System (COFIS, in Portuguese), which has the following competence:

- To plan, coordinate, direct, supervise, control and evaluate tax examination activities of taxes and federal contributions, except those pertaining to foreign trade encumbrances.
- To perform studies for the subsidy of the definition of examination plans and programs; and
- To administer special tax control instruments.

To execute its functions, COFIS developed quality computerized information systems, namely:

1. Computer support systems for Taxpayer Selection

The technical and impersonal selection of taxpayers for inspection is performed through the Fiscal Action Generating System (SIGA, in Portuguese), developed in specific versions for the selection of individuals and corporations. Systems are based on the analysis of internal data from the SRF, including the analysis of balances, as well as in other accounting and fiscal auditing criteria and internal data cross checks with externally collected data, that is before other public branches or before private entities.

Systems provide support for the formation of selected taxpayers dossiers, so that the Fiscal Auditor of the SRF (AFRF, in Portuguese), has at hand all pertinent information when programming to practice auditing tasks. Files generated are integrated to specific applications developed in the examination scope and, to databank applications as well that allow to add greater agility to the works of the AFRF, mainly regarding the treatment of large data volumes.

Auxiliary applications for the external data collection work exist, such as formatters, verifiers and file transmitters in magnetic means, which procure to speed up collection and broadening of the universe of information sources in support to the selection of taxpayers.

In this manner, the SRF's Examination System uses programmed examination procedures with the general lines defined in the Action Plan and based on the technical and impersonal selection, focused, directly towards the increase of the inherent risk, upon incurring in tax violations and indirectly towards the increase in tax collection.

2. Computer support systems for the execution of the Fiscal Action

The Examination Program of the Federal Revenue Secretariat is implementing a computerization culture to its procedures.

It is important to point out that the Federal Revenue Secretariat, in spite of experiencing budgetary restrictions during the past years, has been able to develop a maintenance and upgrading policy of equipment and software. This upgrading is fundamental, considering that the volume of data with which we work in auditing tasks has significantly increased.

In this regard, to qualify approximately 2,400 Fiscal-Auditors, to develop examination activities, the Federal Revenue Secretariat, through the General Coordination of the Examination System (COFIS), bought portable equipment, notebook type, and developed different kinds of software and applications, such as:

- **Auditing – Accounting System**

The Auditing – Accounting System has been conceived for the examination of the accounting of large businesses, when the same is developed in magnetic media. Implemented in December 1997, the Fiscal – Auditor Support System in the accounting and tax examinations of a determinate taxpayer, provided increase in examination productivity because it allows the management of large magnetic files, by means of the use of computerized examination and investigation processes.

The system allows the complete management of accounting data, as well as taxpayer accounting and fiscal books.

- **Tax Invoicing – Auditing System**

This system has been developed to support the Fiscal Auditor in investigations based on tax documentation (input/output tax invoices) and tax records books, using data provided by the taxpayer and prepared in the format required by the Treasury.

The system processes, verifies and analyzes the taxpayer's tax data, it issues input, output and IPI verification registry tax books, in addition to allowing the transfer of information to other systems.

- **Examination Documents System**

In searching for greater efficiency and effectiveness in the execution of Examination procedures, COFIS developed a system called Examination Documents, which is a tool directed towards the rationalization, systematization and standardization of the external auditing activity. The system also allows to reduce the time used by the Fiscal Auditor in auditing activities, in addition to providing greater consistency, reliability and security in constituted tax credits.

Through this system the registry of all examinations practiced by the Fiscal Auditor are possible, as well as the import of the taxpayers' magnetic files, pertaining to the taxable base of taxes and recollected values, for the proper comparisons with the debt values.

- **SAFIRA System**

The constitution of tax credits though the electronic issue of the violation notice or the Eviction Notice of the tax credit, it also deserved the special attention of COFIS. In this regard SAFIRA System was developed.

The objective of the system is to rationalize, speed-up and uniform the formality proceedings of the Violation Notice or the Eviction Notice, upon authorizing the electronic issue of these procedural steps, as well as the verification balances of the tax and the estimate of the fines attributed.

3. Procedure Manuals for the Execution of the Fiscal Action

COFIS, upon searching the qualification of tax auditing procedures to be adopted regarding concrete situations, faced during the performance of the Fiscal Action, developed Examination Manuals for the Examination of different taxes, the same are kept updated and enriched with the prevailing jurisprudence and doctrine.

These manuals are developed in hypertext, the same are annually updated:

- Corporate Tax Examination Manual
- Individual Income Tax Examination Manual
- Withholding Tax Examination Manual
- Financial Operations Tax Examination Manual
- Industrialized Products Tax Examination Manual
- Rural Territory Tax Examination Manual

Taking into consideration the frequent verification of the offenses cases against tax ordering, in addition to the instruments and manuals mentioned, COFIS developed an orientation, standardization and communications facilities manual of the facts that characterized such penal offenses for the Federal Public Ministry.
The “Fiscal Representation Manual for Penal Purposes” contains instructions to be observed by Fiscal Auditors in the instruction of processes that have as a purpose the communication of facts that in theory, characterize crimes against tax order. This representation shall allow the filing of a complaint for the offense and consequent penal process against the infringing taxpayer.

4. Examination System Working Plan

Examination guidelines are annually established based on technical and impersonal criteria, seeking to raise the infringing taxpayer's risk level and indirectly, to increase tax collection. In this manner the Examination System Working Plan is set.

The preparation of the annual Working Plan takes into consideration, the availability of human resources and auxiliary activities inherent to the examination System such as proceedings, skills, etc. The Working Plan prepared is submitted to periodical quantitative and qualitative evaluations, regarding its compliance. These evaluations are sent, quarterly to all regional administrator, so that if necessary, due corrections are to be applied as well as the distortions in the development of the Plan.

Among the guidelines established by the Examination System the examination of large and medium size taxpayers appears, as well as for financial institutions and the beneficiaries of tax incentives. For the year 2001, it is of priority, in addition to actions towards taxpayers that present inconsistencies between the values declared and the values registered through financial institutions.

The objectives of the Federal Revenue Secretariat are to completely reach in a four-year term, the universe of large taxpayers. In this regard, the Working Plan established as a goal an annual coverage of 35% of large businesses for inspection.

In the year 2000, the Federal Revenue Secretariat achieved, through a direct examination action, the following percentages:

Taxpayers according to size	Amount – Year 2000		
	Existing	Examined	%
- Large Taxpayers	2,482	1,119	45.08
- Medium Taxpayers	29,730	5,621	18.91

For the Working Plan purpose, large taxpayers are business with an annual gross income higher than R$50 million and medium taxpayers are business with annual incomes between R$ 3 million and R$50 million.

5. Fiscal Networks

Independent from *in locu* examination procedures, the Examination System performs, through computerized procedures, the summary review of all income tax returns filed by individuals and corporations.

This procedure is called Fiscal Network and allows to quickly and precisely analyze, regarding the consistency of the data and the validity of the information all returns filed. Returns that have an incidence in the guidelines defined are withheld for individual analysis, and the fault presented, according to the case, may be the purpose of fiscal actions.

The main objective of Fiscal Networks, is to guarantee, through mass procedures, the presence of the tax administration before the large amount of taxpayers, by providing, in this way a greater risk rate for the infringing taxpayer. So, the quantitative result of the tax credit constituted is secondary, it is important to mention the scope of the fiscal presence in this system.

In the year 2000 the Examination System presented the following results in the launch of the tax credit:

Individual Taxpayers		
Procedure	**Amount**	**Value in R$**
Direct Examination	9,682	646,913,192
Fiscal Network	47,002	76,242,683
Total	**56,684**	**723,155,875**
Corporations		
Procedure	**Amount**	**Value in R$**
Direct Examination	13,540	27,474,398,163
Fiscal Network	7,301	1,950,630,343
Total	**20,841**	**29,425,028,506**
Total		
Procedure	**Amount**	**Valor en R$**
Direct Examination	23,222	28,121,311,356
Fiscal Network	54,303	2,026,873,026
Total	**77,525**	**30,148,184,382**

For the Working Plan purpose large bodies corporate are considered as businesses that have annual gross income over R$50 million and medium size businesses those that have annual income between R$ 3 million and R$50 million.

b) Computerized assistance and facilities for the taxpayer

Taxpayer assistance, in the Federal Revenue Secretariat units, previously experienced serious problems. The organization's structure, oriented to specialized systems by technical area, prevented the visualization of this service as an activity per se.

Consequently, taxpayer assistance was not provided in a reserved private space or in an appropriate and adequate place, and the officials assigned did not received pertinent training.

Each system exercised internal activities and taxpayer assistance activities, there was no specification of procedures among the different windows. Therefore, when entering into the SRF Offices taxpayer had to pass through the different sectors to solve the same problem, therefore obtaining different informations. The official for his part, partially solved the complaint, that is, only in his area of action, without having a complete view of the process.

This dissemination of activities resulted in the taxpayer's pilgrimage through different places, sometimes in different buildings, without proper guidance.

In summary, the attention model in place prevented the official from completely visualizing the taxpayer; however, in the taxpayer's point of view there was a fragmented SRF office.

1. Taxpayer Assistance Centers – CAC

As from the pioneering experiences and after recognizing the problems mentioned, the basic lines of the new customer assistance model that would be implemented nationally, called Taxpayer Assistance Center (CAC, in Portuguese) were set forth. Currently, the CAC is implemented in all units of the Federal Revenue Secretariat.

CAC operates in its own environment and is organized pursuant to the complexity of the activity. It also has telephone assistance and an official to clarify doubts regarding tax legislation interpretations. Taxpayers have efficient, quick and conclusive assistance.

2. Virtual Assistance – Internet (www.receita.fazenda.gov.br)

Three reasons determined the selection of the Internet as an assistance means: interactivity, flexibility and savings.

a) The Internet has almost unlimited possibilities to collect information, being a privileged channel to comply with accessory tax obligations. On the other hand, the citizen may obtain from the Web page a wide range of information, previously only available through personalized attention.
b) The Internet has a highly flexible interface being able to be adapted to different situations and contexts, in addition to allowing the use of a user-friendly graphic and visual list. There is also the flexibility to develop new products and the programming languages used facilitate the connection of macro and micro processing environment applications.
c) A third reason for the selection of the Internet has been its implementation and operations costs, for the Tax Administration as well as for the taxpayer.

Created in 1995, the SRF's page in Internet has 8,600 linked documents and has already been visited and has served approximately 85 million taxpayers. Among the main services offered by these means we have:

- The receipt of returns,
- Provision of programs and files;
- Individuals and corporations registry inquiries;
- Issuance of clearance certificates for individuals and corporations;
- Individuals Income Tax refund inquiries;
- Attention through e-mail;
- The completion and filing of simplified return of an individual and on-line exemption statement, duly completed.
- Regularization of the tax situation of a corporation and an individual linked to the same;
- Authentication of procedures: certificates issued and tax procedures mandates.

As a future perspective, the SRF develops, among others, the following projects:

- The creation of the self-attention system to citizens with the use of the Internet platform and services;

- Implementation of the digital certification system, that will allow the citizen to obtain information protected by tax secrecy;
- The availability of a tax payment portal.

Through the chart below, the usage level and interactivity that Internet provides is estimated in the Treasury – Taxpayer relationship.

SRF's Web page in Internet

Services / Information	1998	1999	2000	2001*
Web page access	10,328,600	23,749,967	50,398,482	9,439,713
E-mail Received	64,500	154,053	207,463	68,028
Files and Programs Provided	792,210	4,947,453	11,312,494	2,361,673
Tax Returns Received	4,422,720	12,434,683	19,084,439	519,462
Exempted Returns	3,935,540	13,913,071	7,885,223	0
IRPF Refund Inquiries		13,280,052	17,256,125	1,524,147
Individuals Registry Position Inquiries			30,831,686	11,908,436
Clearance Certificates Issued		2,212,300	513,018	
Mean Daily Hits			1,565,781	1,893,229
*01/01 to 02/28/2001				
Mean Daily Accesses	**14,129**	**32,490**	**236,613**	**159,995**

The Federal Revenue Secretariat performed a large investment in Internet attention services and this service has been qualified in such a manner that its page has been awarded and worldwide recognized with the "Dentre Dentre" of the most important awards, among these we have:

Awards received by the Internet Page of the Federal Revenue Secretariat page

- Ibest 2000 – 1st Place of the Official Jury / Popular Jury and Public Services
- Citizen Prize in Internet – CONIP 2000
- Receitanet Case –Microsoft Recognition
- Ibest98/99 – Government /Associations – 1st Place Official Jury / Popular Jury

- IW Best 98/98 – Government /Associations – 1st Place Official Jury
- Hélio Beltrão Award
- CONIP 98 Award – Public Services
- Top of Internet – ADVB

We hereinafter present correspondence from Microsoft Brazil directed to the Federal Revenue Secretariat:

> *"We are highly satisfy to announce to you that the Receitanet – Income Tax Filing Return through Internet "case" has just been published in Bill Gates "Business at Speed of Thought" site which is being simultaneously launched with the book of the same name.*
>
> *The Receitanet has been selected, among other cases, because it is a novel worldwide solution and because it attends the requirements defined by Bill Gates in his concept of "Digital Nervous System".*

3. Telephone Assistance (Receitafone 0300-78-0300)

Implemented on March 31st, 1998, the Receitafone is the telephone attention computerized service of the Federal Revenue Secretariat, which does not require staff.

With this service, the taxpayer through a simple telephone call done from any place in the country, may obtain information pertaining to taxes and other services provided by the Federal Revenue Secretariat, as well as comply with tax obligations.

Receitafone operates continuously and guarantees comfort, speed and security to the taxpayer, in addition to reducing the flow of public to the SRF offices, reserving this attention for more complex cases. It is not common call center, but a system that explores all technological possibilities available in the attention for the most varied services.

The service is available for access through fixed telephone and cellular, call originated from abroad and maritime mobile service, with continuous operations. The telephone for national calls is 0300-78-0300 and for international calls 55-78300-78300.

When attended the taxpayer is directed by programs messages upon pressing the telephone's dial pad with the codes corresponding to the desired issues.

Since its implementation, the **Receitafone** received over 32 millions calls, consolidating itself as an efficient citizens' service. The main information and services available in **Receitafone** are:

- Refund of Individual Income Tax;
- Exempted returns;
- Consultation on fiscal status of corporations;
- Consultation to Individuals' Registry – CPF;
- Consultation to CPF's application process;
- Payment of Income Tax installments;
- Clearance Certificates;
- Individuals' Income Tax Return;
- Corporate's Income Tax Return;
- Tax Agenda;
- Selic Interest rate;
- Fiscal Recovery Program (REFIS).

4. RECOVERY OF TAX CREDITS

Tax administration must develop adequate policies with views make available, for taxpayers in economic and financial difficulties, conditions for the compliance with their tax obligations. These policies, however, must not serve as an incentive to infringing taxpayers or create expectations of obtaining a pardon of debts or any other benefit of this nature.

Policies granting *tax amnesty* constitute a negative stimulus for good taxpayers in the voluntary fulfillment of their tax obligations, apart from being a deep disrespect to honest and reliable taxpayers. Infringing taxpayers are always expectant of ways to free themselves from unfulfilled tax obligations. Such concession is a clear discredit to the tax administration and to its servants, apart from being a negative example for society and a negative education factor for taxpayers in general.

It is a debatable power in all aspects, as it should remain solely in one sense within legislation: in cases where the charges are for small amounts, whose collection costs more than the amount to be

collected. The condonation of sanctions for delinquency can still be considered within the hypothesis of promoting collections of taxes with difficult recovery, as for example the case of taxes under judicial scrutiny. But these are very specific cases and, even so, of difficult political acceptance by the society.

Brazil's experience

Due to economic difficulties and credit and financial restrictions undergone by the country between 1994 and 1998, several tax pardon projects were seen at the National Congress throughout this period. Difficulties faced by the companies (among them, countless small and medium sized businesses) were indubitable and the political environment was rather favorable for the approval of some type of tax benefit of this nature.

The solution came, in 1999, with the proposal of ample business tax recovery program, called ***FISCAL RECOVERY PROGRAM – REFIS,*** split into two phase: the first one of a taxation nature; the second, of a financial nature.

In the taxation aspect, REFIS was destined to create conditions to enable businesses to regularize tax and social security debits. In general terms, with the exception of direct administration entities of public enterprise, of autonomous entities, of the financial system companies and of *factoring*, all the other companies were able to enter REFIS.

REFIS is a special tax and social security debit consolidation and amortization regime (including interests, penalties and monetary corrections), where all company past due debits, in its capacity of taxpayer or responsible party, of a taxation and social security nature, even those recorded under active debt, were consolidated, for payment in monthly amortizations.

The amount of each monthly payment of debits consolidated under REFIS has been established considering the payment capabilities of the company, namely: in a variable percentage applied on the company's gross revenues. This percentage will change according to the tax payment mode adopted by the company for the payment of income taxes (*real profit – companies with a balance, estimated profits – way of calculating taxes based on billing; - SIMPLES – simplified tax payment system for micro and small companies*).

Additionally, REFIS stimulated the inclusion of tax credits *sub judice* or in administrative debate, as well as the spontaneous confession of any other previously undisclosed debt.

On the other hand, REFIS allowed for an adjustment of all individuals' credits and reimbursements, of a taxation and social security nature, including there all tax credit amounts imbued in *tax losses* (calculation of Income Tax) and the *negative calculation bases* of the CSLL (calculation of Social Contribution on Net Profit).

In turn, tax administration made demands focused on guaranteeing entry into credits, such as: *the non-payment of taxes and contributions; the opening of Banking secrecy to the Treasury; the filing of special returns and the possibility of special fiscal follow-up; the non-suspension of company activities, among others.*

Likewise, the company could be excluded form the REFIS, when (being the amount of its debit immediately collected by means of a tax execution): *it executes whichever act aiming to withdrawing revenues; has its bankruptcy or windup decreed, due to the windup or cessation of the body corporate; does not disclose its debits in a non-retractable and non- revocable manner; is not up to date in its contribution for the FGTS – Time and Service Guarantee Fund – Rural Territorial Tax, if taxpayer for these taxes.*

The deadline for incorporation into the REFIS expired on December 13, 2000, having considered 128,000 companies, and most of them composed by small and medium sized companies. Federal Revenue Secretariat maintains a strict control over this taxpayer's universe, both with respect to the possibility of performing tax evasion as well as to the default of filed and consolidated debits.

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Case study:

TOPIC 1.2

THE SOCIAL AND POLITICAL LEGITIMIZATION OF THE STRUGGLE AGAINST TAX EVASION

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CONTENT: Introduction.- Taxpayer Registration Number (TRN) System.- Current Obstacles in the Struggle Against Tax Evasion.- Minimizing the Possibility of Tax Evasion Through Internal Security Within the Tax Administration.- Improving the Control of Tax Evasion.- Recent Initiatives in the Struggle Against Tax Evasion.- Conclusion.

INTRODUCTION

I have always been surprised that in my country there have been a number of seminars and discussions on the topic of white-collar crime and similar types of fraud and invariably very little mention is made of tax evasion. As a matter of fact, some persons will mention all the various types of frauds that take place in business by workers and very little is said about those carried out by management and directors of companies.

It is my opinion that the most far-reaching and costly type of white-collar crime that takes place in Jamaica today is tax evasion, which is practiced by persons from all classes of society. However, because it is not generally regarded as a crime and it is the higher income persons that benefit most from this activity, the tendency is to treat most cases of tax evasion as purely a civil matter. In the circumstances, investigations of these cases are geared primarily at generating additional taxes and penalties rather than making more serious efforts at prosecuting tax evaders.

The net result is that we do not benefit from the deterrent effect of prosecution and tax evaders realize that it is simply a matter of being able to pay the assessed sums. As a result the risks associated with tax evasion are not that great and a substantial number of persons especially those that operate within the informal sector opt to evade their tax obligations.

It is for this reason why when we embarked on the Tax Administration Reform Project, one of the primary objectives was to control tax evasion so as to improve the equity within the system and also encourage a higher level of voluntary compliance.

TAXPAYER REGISTRATION NUMBER (TRN) SYSTEM

At the outset of the reform project it was realized that one of the weaknesses of the tax system was that the base was narrow and there were many persons especially among the ranks of the self employed who were not known to the tax authorities. In order to broaden the tax base, it was decided to introduce a Taxpayer Registration Number (TRN), which would be unique to every person who interacts with the revenue services. This number would be a requirement for all persons who have to do business with any of the Revenue Departments. Initially, there was some resistance on the part of some persons to apply for this number and to provide the necessary information in order to be properly registered. In addition, we had to be sure that the information received was correct and unique to that person. However, over a period of five (5) years we have been able to register one million and Seventy-One Thousand, One Hundred and Twenty-One persons (1,071,121) out of a population of two million six hundred thousand (2.6M) persons resident within the country. It is estimated that there could be about 1.2 million potential taxpayers within the population.

While there are some persons still to be registered, they may have to be force registered through field surveys and other enforcement efforts. However, based on the number now registered, we feel satisfied that we will be able to work with the current list to ensure that the persons who are eligible to make tax contributions are known to the tax administration. We have also since October 2000, gone a step further by introducing a new driver's license system which will have as the number, the TRN of the applicant. This system is one wherein applicants must renew their licenses every five (5)

years on their birthdays and therefore over a period of time all holders of driver's licenses will have their numbers converted using the TRN.

In the case of bank accounts, the Revenue Administration Act also requires that financial institutions utilize the TRN of the depositor for purposes of providing information to the tax authorities regarding such depositor. What is also interesting is that we have noted that a number of other agencies have come to realize that this system is very reliable and therefore they have been asking persons doing business with them to provide this number as a means of making sure that they are who they say they are.

CURRENT OBSTACLES IN THE STRUGGLE AGAINST TAX EVASION

In most societies today, the collection of tax revenues for the provision of common services to the members of the society is something which is generally accepted by a majority of the population. In Jamaica, however, there are those persons who for reasons such as those mentioned below are not willing to voluntarily make their correct contributions.

(i) Because there has been a downturn in the economy for the past few years, the government has had to borrow large sums both on the domestic and foreign markets and this puts a severe strain on the budget. The current percentage of debt to Gross Domestic Product (GDP) is approximately 150%. As a consequence, after the repayment of interest and debt, very little is left in the budget to meet housekeeping expenses to fund government's social and welfare programmes. The response of many people to this situation is that *'they are not getting value for their tax contributions'* and feel justified in not paying their correct taxes.

(ii) The second reason which is sometimes put forward is that even where the funds are being spent by government, there is a tendency based on the reports submitted to Parliament by the Auditor General and the Contractor General for person to feel that because of the waste, inefficiencies and in some cases outright corrupt practices that take place within some government agencies, they are reluctant to make their rightful contributions.

(iii) A third point that is made is that because of the fact that the tax system is not at an acceptable level of efficiency and effectiveness, there is a great deal of inequity within the system and this provides further justification for some persons not to voluntarily comply. It is even argued that it is "those who play by the rules who get shafted".

While there is no doubt that a fair amount of what has been highlighted above is true, at the same time serious efforts have been made to overcome these problems. A major Public Sector Modernization Programme has been undertaken and within the tax administration, a Reform Project has recently been implemented. From all indications a great deal of the problems are being slowly eradicated from the system.

What is of note, however, is that because that some of these practices were allowed to take place for quite a long time, it is now a slow and painful process to change the behaviour of those persons who had been used to behaving in this way for a number of years.

It is also now clear to most persons that this anti-social behaviour is part of what is wrong within the country and has accounted for some of the failures of the past years. To put it bluntly, we need to collect the taxes due so that the government can balance its budget and not seek to borrow more to help with the budget. If we are to succeed in this highly competitive and globalized economy, a first step will have to be taken to stamp out these practices, which have had a major negative impact on the economy.

As a show of its commitment, the government has passed in Parliament the Corruption (Prevention) Act 2000 which seeks to make new provisions for the elimination of corruption in the performance of public functions and to provide for matters incidental thereto. The Act requires that public servants must furnish statutory declarations of assets and liabilities and income. In addition, it has increased the penalties for acts of corruption to fines of up to One Million Jamaican dollars or to imprisonment for a term not exceeding two years or to both fine and imprisonment.

MINIMIZING THE POSSIBILITY OF TAX EVASION THROUGH INTERNAL SECURITY WITHIN THE TAX ADMINISTRATION

The struggle against tax evasion requires that the examination function must create among taxpayers a high perception of risk. Where the perception of risk is weak, there will be a strong incentive for non-compliance and more and more taxpayers will be tempted to evade the taxes. Experience has shown that a tax administration that is staffed by professionals who carry out their work in an efficient and effective manner is more likely to succeed in minimizing tax evasion. It is important therefore that the honesty and integrity of all persons employed within the tax administration be established prior to them being employed. This can be achieved where applicants for employment are subject to a pre-employment background check. Certain basic information should be requested from all applicants and utilized for a security screening. Applicants should be advised that the information provided will be used for that purpose and therefore it is important that they provide complete and accurate information. Any discovery that false or misleading information is provided will lead to the withdrawal of any offer of employment or if the employment has commenced, it will result in disciplinary action, which may include dismissal.

The purpose of the information is to determine suitability for employment within the tax administration by attempting to ascertain whether there is any indication that the applicant has anything in their history, which might conflict with the mission of the tax administration.

In addition to the basic security information requested at the time of application, successful candidates will be required to make a declaration of assets, liabilities and income (including that for their spouse and children) and this information will be upgraded on an annual basis. This information will be used to ascertain whether or not the ‘increase’ in net worth is in line with the declared income of the employee and where this is not the case, further clarification will be requested.

In Jamaica, such a system has been designed and is to be put into effect at a date to be announced later in the year. It is expected that the system will help to ensure that the persons who work with the tax administration are persons of integrity, thereby reducing the likelihood of collusion between taxpayers and tax officials working together to evade taxes.

IMPROVING THE CONTROL OF TAX EVASION

In 1999, the Government amended the Revenue Administration Act (RAA) to provide for the following:

(i) Disclosure of information from any Tax Commissioner to another Tax Commissioner or officer of a revenue department who has, in any particular case, been authorized by the Commissioner of that department.

(ii) The production and inspection of any information, document or record in the possession of certain persons which is relevant to the duties of a Commissioner in relation to:

a) making an assessment in relation to a taxpayer under any relevant law;
b) making an investigation into any case involving tax evasion or for the prevention of fraud on the revenue;
c) determining the tax liability of a taxpayer under a relevant law; or
d) collecting any outstanding amount owed by a taxpayer on account of tax, penalty, interest or fine under any relevant law.

The persons referred to above include:

- a bank licensed under the Banking Act;
- a financial institution licensed under the Financial Institutions Act;
- a person registered under the Public Accountancy Act;
- a society registered under the Cooperative Societies Act or the Industrial and Provident Societies Act, as the case may be;
- a person who is or has been, a party to any business transaction with the taxpayer in question.

It is important to note that this provision require the Commissioner to obtain an Exparte Order from a Judge in Chambers.

(iii) The power of search and seizure where there are reasonable grounds for suspecting that fraud has been committed by a taxpayer and evidence of such fraud is to be found on premises specified in the information presented to a Judge of the Revenue Court.

Where during a search of any premises or in the course of any audit, inspection or examination, a Commissioner or any authorized person is of the opinion that it is necessary for the protection of the revenue to impound books, records or other documents found on those premises, the Commissioner or authorized person may take such books, records or documents into his custody. The taxpayer however will be permitted to make copies on request.

(iv) Where an offence against the Act is committed by a body corporate, the liability of whose members is limited, then notwithstanding and without prejudice to the liability of that body, any person who at the time of such commission was a director, general manager, secretary or other similar officer of that body or purporting to act in any such capacity shall be liable to be prosecuted as if he had personally committed the offence and shall, if on such prosecution it is proved to the satisfaction of the court that he consented to, or connived at, or did not exercise all such reasonable diligence as he ought in the circumstances to have exercised to prevent the offence, having regard to the nature of his functions in that capacity and to all the circumstances, be liable to the like conviction and punishment as if he had personally been guilty of that offence.

This Act was in the Parliament for approximately two (2) years and was subject to a great deal of scrutiny by both Houses of Parliament, members of the Business and Professional Associations and the general public. However, it was eventually passed with twenty-five (25) amendments.

RECENT INITIATIVES IN THE STRUGGLE AGAINST TAX EVASION

Prior to June 1999 there was a substantial loss in revenues from the evasion of income tax on investment income although there was a law in place which required that income tax of 25 cents in the dollar (25%) be deducted from interest paid by certain financial institutions, Some investment dealers and other institutions found creative ways of taking funds from clients and making returns in such a manner that the withholding tax provisions did not apply. Because of this loophole, a number of persons moved their funds to those instruments that were not subject to the withholding tax. In

the case of Building Societies, the Income Tax Act actually stated that there should be no deduction of tax in the case of 'share interest'. In the circumstances, it was left to those earners of interest and other forms of investment income to file their returns and pay the tax due.

Needless to say, the statistics showed that as much as seventy-five (75%) of the recipients of these sums did not file or return the correct amount of investment income. In order to deal with the loss in revenues, the government amended the income tax law to make it clear that the withholding tax would apply to all the various instruments by 'deeming' the returns to be interest. The move has resulted in the withholding tax on interest moving from $2.6Billion Jamaican Dollars in the period April 1998 - January 1999 to $9.2 Billion Jamaican Dollars in the current fiscal period of April 2000 - January 2001, thereby reducing the reliance on collections from Pay As You Earn (PAYE) and improving the equity within the tax system.

The other initiative in the struggle against tax evasion, which is bearing fruit, is the move to implement an Integrated Computerized Tax Administration System (ICTAS) throughout the tax administration. Because of the amendments to the Revenue Administration Act with regards to the exchange of information, it is now possible to have information from all the various tax agencies within one computer system and available to auditors, investigators and compliance officers. Auditors and Investigators will now be able to access the following information from the various systems:

a) Motor Vehicle Registrations
b) Sales/Purchase of Real Estate and other Instruments, which have to be stamped at the Stamp Duty and Transfer Tax Office.
c) Import/Export information, and
d) Real Estate holdings from the Land Valuation System.

This information has been of tremendous value in the audit and investigation of cases and as a basis for computing estimated assessments.

CONCLUSION

Despite the efforts of government and the tax administration to enforce the tax laws in order to be able to provide the public with the necessary goods and services, the economic and technological environment of the tax administration have generated new challenges as well as new opportunities. Digitalization and globalization have made it more difficult to ascertain taxpayers income even where they are required to include all their income from both within and outside of the country. More and more tax administrations will have to cooperate through Exchange of Information Provisions in Tax Treaties in order to make it clear that they have the means and political will to enforce the laws where non-compliance is suspected. If they are to overcome the challenges and make use of the opportunities, they will have to fully utilize modern computerized systems and workers will have to be fully trained to embrace the new technology.

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Case study:

TOPIC 1.3

THE INSTRUMENTS FOR THE MEASUREMENT OF TAX EVASION

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1. INTRODUCTION

Having available information with respect to the amount of tax evasion is important for varied reasons. First, it allows the administration (hereinafter, TA) to better orient its examination function. If the TA would have estimates on tax evasion, evasion mechanisms, geographical zone or economic sector, it could better allocate its resources for improving its effectiveness. Secondly, it allows for measuring the results of the examination plans and making modifications whenever necessary.

Finally, tax evasion may be used, with certain limitations, as a measure of effectiveness of the TA. The government must take evasion into consideration when deciding the TA's budget, as well as when analyzing eventual modifications to the tax

legislation. Generally, the government and parliament determine the tax structure and budget of the TA, but delegate to the latter the responsibility of collecting taxes. From there follows the importance of the use of indicators for measuring the performance of the TA. If the objective assigned to the latter is to improve tax compliance, then the appropriate performance indicator is the rate of compliance: other factors being equal, the greater the rate of compliance, the better the performance of the TA.

Within the context of the above statement, it is essential to count on figures about the level of tax evasion of the economies. The purpose of this presentation is precisely to provide a synthesis of the methodologies developed in recent years for measuring evasion, with particular emphasis on the work carried out in Chile in relation to different taxes and under different measurement methodologies and present the results in order to contribute to the current and future discussion of the issue.

Measuring evasion, is not an easy task. For obvious reasons, direct questioning is the less reliable form for observing this variable: the agents involved will hardly disclose how much tax they may have omitted in a given period, even though guaranteed total anonymity. On the other hand, it could be that many taxpayers do not even have a precise quantification of what they evade. In this sense, measurement methods must follow indirect paths for obtaining more reliable results.

There is scarce economic literature on the subject. There is greater development with respect to the methodologies for estimating the size of the informal or underground economy. Obviously tax evasion and informal economy are not synonyms[1], nevertheless, the more formal development of these methodologies and their relative ease of application have led some countries to use these estimations as an approximation to tax evasion. The methodology most frequently

[1] *The informal or underground economy comprises all activities not registered in official figures, which may be legal or illegal, and may correspond to market transactions or else, to activities occurring outside the market (e.g. domestic work). However, not all activities involve tax evasion. For example, domestic work is an informal activity, but does not affect taxes. Likewise, remunerations received by workers from the informal sector may not involve tax evasion, if the income is within the exempt bracket.*

used for these purposes is the 'demand for money', whereby informal transactions assume the form of cash payments. Therefore, an increase in informal transactions should be reflected in an increase of the demand for money.[2]

Tanzi (2000), notes that one of the inconveniences of the methodologies for estimating the underground economy is that, when applied to a same country, they show divergent results. For example, Schneider and Enste (2000) compare results of nine different methods for estimating the size of the informal economy, which expressed as percentage of GDP, provide results ranging between 1,4% and 21,2% for Canada; 8,2% and 34,0% for Germany; 9,3% and 21,3% for Italy; and between 6,2% and 19,4% for the United States.

As for the methodologies whose purpose is the measurement of tax evasion, there are two widely diffused approaches. A first approach based on the 'theoretical potential' resorts to related variables to come close to determining collection that would be obtained if all taxpayers would pay their taxes, which can then be compared with effective collection for determining evasion. A second approach of a 'sampling' nature uses the capabilities of the tax administration for detecting noncompliance, by examining a representative sample of taxpayers and then extending its results to the universe thereof.

The rest of the report has been organized as follows. Section 2 reviews the Theoretical Potential method using National Accounts, specifically its application to VAT and income tax, and analyzes its main advantages and limitations. Section 3 illustrates the use of budgetary surveys for measuring evasion, by means of two applications, one for measuring individual income tax noncompliance and the other for measuring VAT evasion. Section 4 analyzes sampling methods for measuring evasion, in the light of the U.S. Internal Revenue Service's experience and of a specific application made in Chile. Section 5 shows a method of tax information conciliation, applied to the estimation of VAT evasion by means of false invoices. Lastly, section 6 illustrates the use of opinion polls where taxpayers are inquired about their perception of the levels of evasion.

[2] *A summary of the methodologies for measuring the informal economy may be found in Schneider and Enste (2000).*

2. THE THEORETICAL POTENTIAL METHOD USING NATIONAL ACCOUNTS

Many tax administrations have resorted to the theoretical potential method for obtaining estimates, mainly of VAT evasion and, to a lesser extent, of income tax. In general terms, this method involves estimating the potential collection of a tax – that is, the amount which would be obtained if there were no evasion – based on an independent information source, usually taken from the National Accounts (hereinafter, CN). Subsequently such potential collection is compared with actual or effective collection, to obtain a gap that is attributed to tax evasion.

Application to VAT

VAT is a tax applied to most of the economy's transactions involving goods and services. However, because of their operation based on the debit and credit system, these transactions do not generate net fiscal revenues, except when occurring at the level of the end consumer. Thus, the theoretical base of VAT may be related to macroeconomic aggregates as expense in final consumption.

Under this method, known as that of 'nondeductible VAT', the tax base is estimated on the basis of final consumption of homes, from which one deducts the fraction of consumption that is exempt and adds the component of taxed intermediate consumption from the exempt sectors, since the latter become transactions with VAT that cannot be deducted. By applying the tax rate to this theoretical base, one obtains the theoretical collection of VAT, which is compared to effective VAT collection, that is, with collection originating from the taxpayers' returns. The gap between both values, theoretical and effective, is considered evasion.

This method has been applied in Chile for obtaining estimates of VAT evasion in the 1989-1999. The series shows a significant decrease in the rate of evasion[3] from 29% in 1990 to 18.3% in 1993. In subsequent years, it has been around 20%.

It must be mentioned that many TAs from the Latin American countries have applied this method; nevertheless, few works have been published, and they have been rather dealt with in a confidential manner.

[3] *Normally, the evasion or noncompliance rate is defined as the quotient between the evaded amount and potential collection.*

Depending on the level of disaggregation with which the NAs are published, it is possible to obtain evasion estimates by economic sectors. In this case, the taxable base must be estimated as the difference between sales subject to tax, estimated as of the 'Gross Value of Production', and the purchases that allow for credit, calculated as of the 'Intermediate Purchases' and 'Investment'. Many countries have available sufficiently disaggregated information on the occasion of the publication of the Input-Product Matrix, which takes place with a more or less ten-year periodicity. Silvani and Brondolo (1993) use this value added approach to measure VAT evasion in 20 countries in 1992. The results are shown in the following chart.

Chart Nº 1
NET VAT TAX COMPLIANCE IN CHILE
AS COMPARED TO OTHER COUNTRIES – 1992

Country	Rate of Compliance
New Zealand	5.1
Sweden	5.4
Israel	7.8
Portugal	14.0
South Africa	14.6
Chile	**18.2**
Canada	23.0
Spain	26.0
Uruguay	29.7
Argentina	31.5
Honduras	35.4
Colombia	35.8
Hungary	36.3
Mexico	37.1
Ecuador	38.2
Philippines	40.8
Bolivia	43.9
Guatemala	52.5
Peru	68.2

Source: Silvani and Brondolo [1993].

It is interesting to note in the foregoing chart that, in general, the lower rates of evasion coincide with the more developed economies, which was an expected result, given that those countries generally have stronger tax administrations and smaller underground economies.

Application to Corporate Income Tax

Some methodologies have also been developed for estimating noncompliance with corporate income tax. In this case, the potential tax base is estimated on the basis of the Surplus of Exploitation of the NAs, which must be adequately corrected to reflect the differences between this macroeconomic concept and the net income subject to tax. Jorratt and Serra (2000) propose a method for Corporate Income Tax in Chile. In broad terms, the method consists of, initially determining the Theoretical Tax Result of the enterprises, by subtracting from the Exploitation Surplus an estimation of the surplus of activities not subject to and exempt from the tax, the surplus of companies subject to presumptive income and losses from previous fiscal periods –deductible for tax purposes – and adding the adjustments for monetary correction. Thereafter, the Theoretical Tax Base is determined by excluding from the Theoretical Tax Result, the tax losses of the fiscal period, which adjustment is necessary for an adequate comparison with the Effective Tax Result that arises from the returns. Finally, the Theoretical Collection is estimated as the Theoretical Tax Base multiplied by the tax rate, after discounting effective credits against the tax.

This brief description shows that the estimation of income tax evasion requires more adjustments than the VAT method, since the former has more exceptions to the general rule, such as exemptions, special regimes, deferments, etc. For the same reason, the methodologies are less standard and must be developed according to the characteristics of the tax legislations of each country.

It is interesting to observe, in the case of Chile, the evolution of the rate of corporate tax evasion, compared to the series of evasion at VAT. There are two aspects worth noting in the figures shown on chart 2. The first is that the rate of income tax noncompliance is twice that of VAT. The second is that both series show a decreasing trend, with a similar grade, which issue is evident on observing that the quotient between both rates ranges around two throughout the series. Both elements account for a desirable minimum consistency between both methodologies, and allow a certain level of validity to the theoretical potential method as indicator of the evolution of tax compliance. In fact, VAT evasion is almost fully transformed into income tax evasion. An under declared dollar in VAT debits is also

a dollar less in the company's earnings[4]. If to this we add that the TA examines both taxes with equal diligence, then it is to be expected that both rates evolve in a similar fashion. On the other hand, the VAT tax base is always greater than the income tax base. In broad terms, the VAT base corresponds to value added, while the income tax base is value added less remunerations. Thus, the same dollar under declared in sales will represent in percentage terms, a larger amount with respect to the income tax base than with respect to the VAT base, which explains why the evasion rate of the first tax is larger than that of the second one.

Chart Nº2
Chile: Rate of Corporate Income Tax and VAT Evasion
Theoretical Potential Method based on National Accounts

Concepts	1989	1990	1991	1992	1993	1994	1995	1996	1997
(a) Corporate Tax (%)	58.0	49.6	50.0	48.5	44.1	41.1	39.1	41.1	41.7
(b) VAT (%)	29.0	29.6	26.8	22.9	18.3	19.6	20.3	20.0	19.7
(a) / (b)	2.0	1.7	1.9	2.1	2.4	2.1	1.9	2.1	2.1

Source: Barra and Jorratt (1999).

Application to Individual Income Tax

Given the characteristics of the NA information, a requisite of the theoretical potential method is that the tax under analysis have a flat rate, otherwise it is difficult to proceed from the tax base to potential collection. For this reason, there are few works dealing with individual income taxes, since they generally have progressive rates. Some works have been limited to evaluating the gap between the potential and effective tax bases of individual income tax; the first being estimated on the basis of data from the surplus of exploitation and remunerations of the NAs (in the case of Colombia, see Steiner and Soto (1998)).

[4] *Jorratt and Serra (2000) estimate that in Chile, about 75% of income tax evasion results from VAT evasion.*

Limitations of the Theoretical Potential Method Based on NAs

In general terms, the limitations of the method for measuring the theoretical potential are related to the reliability of the source used for quantifying potential collection. In 1996, the Internal Revenue Service of Chile entrusted a group of experts from the University of Chile, the analysis of reliability of evasion estimates according to the theoretical potential method based on NAs, from the standpoint of methodologies as well as of the quality of the information sources used. The conclusion of this study is that the main limitation of these methods results from the limited information used for structuring the National Accounts, with the following being highlighted:

- The use of accounting information from enterprises in some economic sectors, or else, of production surveys, which could involve part of evasion, thus causing underestimations in the calculations of noncompliance.
- The use of tax information for estimating the proceeds for those sectors measured according to activity and not goods, such as the services and industrial sectors.
- The variation of stock is an adjustment variable, in such a way that if consumption is underestimated, evasion would be underestimated and undeclared consumption would be attributed to the variation of stock.
- In the annual estimation of National Accounts, some sectors assume that productivity remains constant; that is, the same as that estimated for the basic year. If there is increase in productivity, this would lead to underestimate the theoretical value added and, accordingly, evasion.

On the other hand, the study also highlights that in the structuring of the National Accounts, there is a conciliation of data originating from other sources of information. If by means of independent information sources (e.g. price or consumption surveys) one manages to capture amounts actually negotiated and their prices, it is possible that there may be no such underestimations or overestimations. Unfortunately, the lack of clearly established criteria in the work of the sectors, prevents the evaluation of this assumption.

Another limitation of this method is that estimates are mostly available, a year later, more or less, and, in general, allow for aggregate measurements. Therefore, it is not a very useful tool for

making decisions with respect to the allocation of resources of the TA or for evaluating the progress of examination programs.

To the above one should add that the most recent figures of the NAs tend to be of a provisional nature and are adjusted every so often. This aspects becomes relevant inasmuch as the estimated rate of evasion is somewhat sensitive to the review of figures carried out by the Central Bank.

In any case, it is believed that the evasion studies using the Theoretical Potential method are useful for determining levels of evasion and its evolution, even though it is not possible to evaluate their reliability.

3. BUDGET SURVEY METHOD

It may be that many tax administrations use the theoretical potential method in a more informal manner, by using sources of information other than the national accounts. For example, one may resort to agricultural production and the prices of agricultural products statistics to attempt the measurement of evasion in that sector. There also tends to be information available on the production and consumption of fuel, which allows for estimating noncompliance with taxes that affect these products, etc.

Another way to estimate potential collection of taxes is through surveys of family budgets and other similar ones. For example, Engel, Galetovic and Raddatz [1998a] estimated individual income tax noncompliance in Chile, using as theoretical basis of the tax the income declared in the 1996 National Socioeconomic Characterization Survey (CASEN).

Estimation begins with the calculation of the tax, which each surveyed individual would have had to pay, according to the corresponding rates scale, based on his annual income. The calculated collection is immediately grouped in income percentages and compared with actual collection declared before the Internal Revenue Service, at the level of those same income percentages. The comparison is made by 'matching' groups of individuals and not at the level of each of them, because there is not sufficient information available for doing so[5].

[5] *The identity of persons surveyed by CASEN that would allow for comparing tax per individual, is not available.*

The method delivers as result an aggregated rate of individual income tax evasion of 57%. The result per decile of income, shows an increasing rate of evasion as compared to the level of income. That is, those taxpayers subject to larger marginal rates under declare a greater percentage of their income.

The main limitation of this method deals with the reliability of the answers of the surveyed. In the case of businessmen, with respect to the question about their monthly income, it is unclear whether the answer refers to the income before or after tax, or if it deals with earnings or only withdrawals[6]. Otherwise, in contrast to dependent workers, many businessmen may not have a clear idea of what their monthly income is.

The Internal Revenue Service of Chile has recently acquired another experience with the application of this method, this time, using the last Family Budget Survey (EPF) performed by the National Statistics Institute between July 1997 and June 1998. The objective was to measure VAT evasion as a result of under declaration of sales to the end consumer. Sales to the end consumer is one of the vulnerable points of VAT, since in this last stage of the commercialization chain there is no counterpositioning of interests between purchaser and seller. Therefore, it is interesting to the TA to be aware of how much is not collected as a result of this evasion figure.

The EPF surveyed some eight thousand homes in Greater Santiago during a twelve-month period, requesting the registration of consumption of all goods and services during said period. In the first place, an estimate was made of annual consumption subject to VAT for this sample of homes. Secondly, this result was expanded to the national universe of homes. Since the survey was carried out in a specific geographical zone, it was assumed that consumption patterns of the families were similar in the rest of the country, having to resort to data of the CASEN survey dealing with the income of homes per region, in order to weigh these differences at the time of the expansion. Subsequently, an estimate was made of the theoretical VAT associated to the consumption subject to tax, which was compared to actual debits declared by the taxpayers. The result was an under declaration of 25% of sales to the end consumer.

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[6] *In Chile, individual income tax is applied to withdrawals of earnings.*

4. SAMPLING AUDITS METHOD

The most direct way of obtaining estimations of noncompliance of a specific tax is through audits of a taxpayer sample. The quality of the results of this method depends on the depth and knowledge with which audits are performed, since they only allow for discovering part of the total evasion. The percentage of noncompliance detected in audits will depend, among other factors, on the experience of the auditors performing them. The representativeness of the sample is also important. The main advantage of this approach is that, if it is done adequately, the whole array of statistical techniques may be applied for determining the levels of trust and accuracy of the results, classifying them according to categories and validating hypotheses, etc. Unfortunately, the statistics on results of audits available in the examination departments are generally not useful for estimating evasion, since they have a selection bias that is difficult to correct (taxpayers audited are those deemed to have a greater possibility of evasion). Accordingly, it would be costly to annual estimate evasion through this method, since it would imply performing audits to an especially designed sample of taxpayers.

The TCMP of the United States

The most widely diffused example of application of this method is the Taxpayer Compliance Measurement Program (TCMP), of the Internal Revenue Service (IRS) of the United States. This program comprises exhaustive audits to a random sample of approximately 50,000 taxpayers, and has been periodically developed to measure evasion in family groups, as well as in small enterprises. In addition, the sample is stratified in order obtain more reliable results in those groups that are, a priori, known to evade more. The latest estimates available indicate that the rate of income tax noncompliance is around 17%.

The TCMP has been used not only to measure evasion, but also to develop methods for selecting taxpayers to be audited. In the 60's, based on the TCMP data, the IRS began to develop discriminant functions to select those taxpayers with a greater probability of noncompliance, thus achieving spectacular results in the effectiveness of the examination process. The percentage of audits that did not bring about changes decreased from 43% in 1968 to 11% in 1990 and the yield of each audit increased from 700 dollars in 1963, expressed in 1982 currency, to 4,400 dollars of equal value in 1990 (see Nelson and Hunter, 1996).

By the way, the sampling method has some disadvantages. Feinstein (1999) mentions the following:

- The most important one is the cost involved in such a program. In general, these audits are more costly than regular examinations. The reason is that regular examinations tend to concentrate on specific aspects of legislation, while those intended to measure noncompliance must be exhaustive and at random, and therefore, longer and with lower yields. According to data from the mid 90's, the yield of a regular audit was 5,500 dollars, while that of a TCMP audit was only 300 dollars.

- Random audits are not acceptable to taxpayers, who feel that they must devote too much time to these activities, which are not even motivated by suspicion of fraud. In fact, the annoyance of taxpayers, along with the high cost of the TCMP, have led the U.S. Congress to reject, in the past years, the allocation of funds to this program.

- Lastly, this type of audits is not very popular among TA managers and inspectors either, since they consider that their work is measured according to the direct yield of examination, and therefore, they do not wish to devote scarce resources in random audits.

The Fixed Point Method

The Fixed Point method commonly used to examine or presume taxpayer payment obligations[7], consists of the visit of an auditor to an enterprise, who on remaining throughout the commercial shift, ensures that perfect tax compliance takes place. This method may also be used to measure under declaration of sales, based on the following principle: a taxpaying company subjected to the control of a field examination, will be obliged to issue invoices for the totality of its sales, in addition to registering them in the pertinent accounting record and subsequently declaring them in the VAT form. Later on, in order to measure evasion, sales registered throughout the control period are matched against sales registered in previous periods under similar conditions.

[7] *In Chile, in contrast to what occurs in other countries, the fixed-point method is not a mechanism supported by the legislation to presume the payment obligation and therefore, is used only as preliminary report for deciding an in-depth examination.*

In practice, the method implies the visit of an auditor to a company –without previous notice– informing that a 'normal' tax control will be carried out and remaining throughout the daily commercial shift. Nevertheless, the real objective pursued through this method is that the presence of the auditor will force the issuance of all invoices for final sales and that the sales information on the stubs of invoices be actually transferred to the sales records. This method was applied in Chile in late 1996 and mid 1997, considering a sample of approximately 300 businesses extracted from the universe of VAT taxpayers issuing sales invoices. SII examiners applied one 'fixed point' day in each company, and obtaining in addition the daily sales information for weeks and months prior to the day of application.

The comparison between the day of control and 'similar' previous days posed some difficulties in practice, on observing a significant variability of sales data. This problem was considered in the statistical processing of data developed by Engel, Galetovic and Raddatz [1998b] in order to try to overcome these difficulties and obtain adequate evasion measures.

The results indicate that taxpayers omit from their tax records, 24.6% of sales to the end consumer, with a standard deviation of 4.8%. In the assumption that these figures are consistent with the estimations of the theoretical potential, it is concluded that 60% of VAT evasion takes place through under declaration of final sales.

How to Use the Results of Regular Audits for Measuring Evasion

The application of a program such as TCMP is not very feasible in the TAs of developing countries, due to the high costs involved in such an activity, compared to the scarce resources available. A method such as the Fixed Point is more feasible from this standpoint. Now then, if one wishes to obtain reliable evasion estimates by economic sector, geographical location or some other relevant segmentation variable, the size of the sample will be considerably greater and hence, the cost of the program will also be greater.

The problem with using statistics from regular audits to infer evasion of the taxpayer universe may be illustrated with the following example: From the audits made by the examination department it is detected that taxpayers under declared in average, 40% of their income and, therefore, they should have declared income for 1000 instead of 600. It cannot possibly be inferred from these results

that the rest of unaudited taxpayers also evade 40% of their income, since, if planning of the audits was adequate, taxpayers with a greater probability of being evaders should have been chosen. In that case, the rate of evasion of the remaining taxpayers is unknown and lower than 40%. However, what can be stated with a higher level of certainty is that if, from the universe of taxpayers we take a group with similar characteristics to the audited group –in terms of economic activity, size, geographical location, etc. – then that group should declare income of approximately 1000. If, on the contrary, income declared was 800, we may estimate evasion at a rate close to 20%.

What we do in this latter procedure is to use the results of the audit to forecast the tax behavior of a taxpayer who does not evade, to subsequently apply such behavioral pattern to the universe of taxpayers with similar characteristics. In this way, the problem with the selection bias is minimized.

Another inconvenience with using the information from regular audits is that they are not exhaustive. In the previous example, it is highly probable that actual evasion of the audited group is greater than 40%. Even if the audit were exhaustive, the auditor will not be able to detect 100% of evasion. This is particularly important in the case of VAT: If a taxpayer sells his goods without a voucher, it is very difficult to detect it in an audit. The control of inventories does not always bring about good results, much less when the businessman sells many products.

A way of separating the estimation of the level of intensity of different audits is to measure the noncompliance of audited taxpayers with the difference in amounts declared before and after the audit. Instead of measuring it on the basis of the amounts detected therein. In fact, there is empirical evidence that the tax behavior of taxpayers improves after the examination actions, perhaps due to an increase in the probability of fraud detection perceived by the individuals. For example, Blumenthal, Christian and Slemrod (1998) carried out a controlled experiment, which involved the sending of a letter to a random group wherein they were warned that their next income tax returns could be examined in detail. Thereafter, they compared the variations in income declared by this group one year, with respect to the previous one, in relation to variations in the income declared by a control sample group that did not receive said letter. The results showed that the effect of the letter was an increase in income declared by low and medium income taxpayers, especially

from those with greater opportunities for evading. Indeed, individual responses to an examination action may be varied, even some taxpayers react by declaring less than they declared prior to the examination. Therefore, these aggregate increases account for only one part of evasion.

The structuring of evasion indicators based on the application of the previously described concepts is an interesting field to be explored. The main advantage of such indicators is that on using information that is daily compiled by the TA speedy and timely results could be obtained, thus becoming useful tools for the planning and evaluation of examination activities.

5. METHOD OF CONCILIATION OF THE TAX INFORMATION

On occasions, the information received by the TA, from different sources, allows for estimating some forms of tax noncompliance, through a conciliation of these data. The exclusive use of tax information has, in addition, the advantage of allowing timely estimates, without the one or two year gaps that are typical of the theoretical potential methods, thus making it a useful indicator for defining examination strategies as stated in the previous section.

The Internal Revenue Service of Chile developed such a method to measure VAT evasion by means of false invoices, which is briefly described below.

In every intermediate transaction, the latter being understood as that occurring between two VAT taxpayers, the seller withhold the tax from the purchase, which is determined by applying the tax rate to the value of the transaction. This amount constitutes at the same time, a tax debit for the seller and a tax credit for the purchaser. An equivalent situation occurs in the case of imports, where the VAT collected by Customs is at the same time a tax credit for the purchase. By identifying VAT credits as CR, VAT on imports as II and VAT debits on intermediate transactions as DTI, then in aggregate terms the following equivalency should take place:

$$CR = II + DTI \qquad (1)$$

IF VAT credits exceed the term on the right, we would be faced with evasion by means of false invoices. It must be noted that in this context the term ‘false invoice’ refers to any enlargement of VAT

credits without the corresponding amount of debits. The amount of evasion would simply correspond to the difference between both terms of the equation. A useful indicator for evaluating the evolution of evasion would be the ratio between both terms of the equation, that is:

$$\text{Indicator} = CR / (DTI + II) \qquad (2)$$

As in other countries applying VAT, the Chilean rules allow two types of sales vouchers: the invoice and the sales slip. The first is used in intermediate transactions and supports the VAT credit. The second, is the one used in sales to the end consumer or to entities that are not VAT taxpayers. The separate declaration of VAT debits originating from each of these two documents allows for approximating the value of DTI for declared amounts of VAT with invoice, subject to a series of adjustments mainly aimed at excluding sales to exempt taxpayers, who normally request an invoice, even though they are not entitled to credit. On the other hand, the VAT credits are declared separately in the monthly form, while the VAT on imports may be obtained from the national accounts. In this way, equations (1) and (2) have been estimated for the 1990-98 period, thus arriving at results shown in the following tables.

Chart N° 3 shows the results of estimates made for the 1990-1998 series. The results indicate that in 1998, evasion as a result of false invoices amounted to $318 billion (approximately US$560 million). On analyzing the indicator, it is observed that this type of evasion was significantly reduced with respect to the early 90's, as has also occurred with global VAT evasion, according to estimates available.

Likewise, assuming that these results are consistent with those obtained through the NA method, one observes that evasion arising from false invoices, in all periods, amounts to over 20% of total evasion, reaching its peak in 1998, with 38.3%. The same chart shows the proposed indicator along with the global rate of VAT evasion, there being somewhat consistency in the variations of both data.

Chart N° 3

Evasion from False Invoices VS Total VAT Evasion according to NA Method
Billions of Pesos of January 2000

Years	False Invoices Evasion (a)	Total VAT Evasion NA Method (b)	(a)/(b)	False Invoices Indicator	Rate of VAT Evasion CA Method
1990	294.8	1,579.0	18.7%	1,052	29.6%
1991	238.3	1,276.7	18.7%	1,038	26.8%
1992	168.4	1,061.8	15.9%	1,026	22.9%
1993	241.0	794.9	30.3%	1,034	18.3%
1994	223.2	798.9	27.9%	1,030	19.6%
1995	172.0	827.3	20.8%	1,021	20.3%
1996	132.4	802.1	16.5%	1,015	20.0%
1997	245.6	722.0	34.0%	1,027	19.7%
1998	317.5	828.6	38.3%	1,034	22.0%

Source: Deputy Directorate of Studies of the SII.

6. EVASION ACCORDING TO TAXPAYER PERCEPTION

When one wishes to know with some degree of certainty, the level of tax evasion of a country, it is useful to approach the issue through several paths, so as to complement and corroborate the results obtained through the standard methodologies. An alternate simple path is to ask the taxpayers themselves as to what they believe is the magnitude of tax evasion. To the extent one inquires about the evasion by others and not one's own, the surveyed will not conceal their perceptions. Certainly, the opinion of the taxpayers may be contaminated with the evasion estimates made by the TAs, if they are widely diffused.

Chart N° 4 below shows the level of perception of tax compliance in each country on the part of the businessmen. This index is part of a series of indicators used internationally to measure the competitiveness of the world economies. The surveyed had to answer the question: Is evasion usual in your country? According to the results published in the 1998 World Competitive Yearbook, Singapore would lead the countries with the lower perception. Likewise, the Latin American countries, except for Chile, are in the lower half of the chart.

Chart N° 4

Level of Tax Compliance in Relation to Other Countries Competitiveness Ranking – 1998

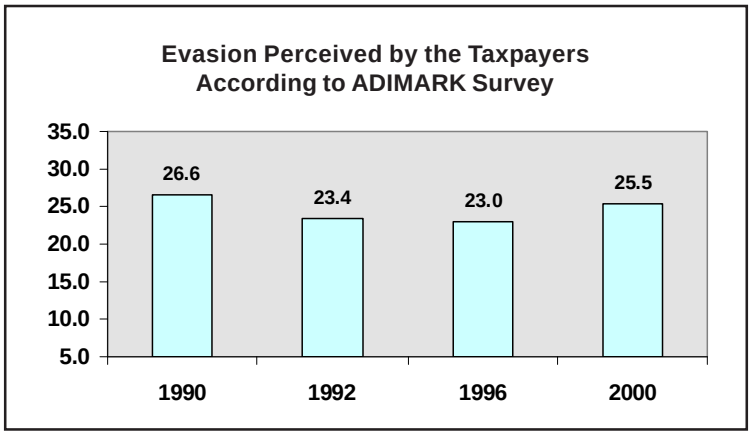
Country	Rank	Index (0 – 10)	Country	Rank	Index (0 - 10)
Singapore	1	8.18	Island	25	4.19
Hong Kong	2	7.68	Thailand	26	3.77
New Zealand	3	7.18	China	27	3.56
Finland	4	7.02	Poland	28	3.23
Chile	5	7.00	Korea	29	3.06
Switzerland	6	6.00	Hungary	30	3.06
Canada	7	6.64	Slovenia	31	2.94
Luxembourg	8	6.57	Portugal	32	2.92
United States	9	6.22	Indonesia	33	2.70
Japan	10	6.15	Italy	34	2.67
United Kingdom	11	6.03	Czech Republic	35	2.54
Malaysia	12	5.94	South Africa	36	2.53
Norway	13	5.67	Brazil	37	2.52
Netherlands	14	5.67	Mexico	38	2.50
Austria	15	5.47	India	39	2.50
France	16	5.44	Belgium	40	2.45
Denmark	17	5.43	Turkey	41	2.44
Spain	18	5.09	Philippines	42	2.39
Israel	19	4.96	Greece	43	2.09
Ireland	20	4.84	Venezuela	44	2.04
Australia	21	4.76	Argentina	45	2.02
Germany	22	4.66	Colombia	46	1.85
Taiwan	23	4.56	Russia	47	0.66
Sweden	24	4.40			

Source: World Competitive Yearbook [1999]

On its part, the Internal Revenue Service of Chile has carried out through Adimark, a series of corporate image studies. These have been carried out in 1990, 1992, 1996 and 2000 through a survey applied to a sample of 300 taxpayers on each occasion. Among other results, one of the main ones is related to the opinion of the surveyed with respect to the level of tax evasion in Chile. As shown in Graph N°1 in 1990, the belief of the interviewed with respect to

the total percentage of evaded taxes was an average of 26.6%. In 1992, this percentage was reduced to 23.4%. In 1996, the taxpayers' evasion belief continued to be relatively aligned with that of 1992, reaching 23%, while the in the latest study performed in the year 2000, it amounted to 25.5%. At this stage, it must be noted that the evasion studies based on the National Accounts were disseminated by the SII starting in 1993, for which at least taxpayer beliefs in 1990 and 1992 should not be influenced by the latter. It calls the attention that the order of magnitude of the rate of evasion perceived by the taxpayers is very similar to that of the estimated rate of the theoretical potential method.

Graph N°1



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TOPIC 2

MASSIVE TAX COMPLIANCE CONTROLS

Lecture:

TOPIC 2

MASSIVE TAX COMPLIANCE CONTROLS

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Massive controls constitute an essential instrument for the detection and regularization of tax noncompliance.

In our tax systems the principle of generality extends tax obligations to all citizens, so it is not inappropriate to speak of the citizen as a taxpayer.

It is true that taxation is not equal for everyone and that the principles of equity and economy capacity govern the tax burden to be borne by every citizen. However, at the outset of the XXI century most citizens, to the extent that they obtain income and enjoy income or capital, have tax obligations to fulfill. This is materialized in the filing of tax returns.

It is also a fact that businessmen and professionals, in their capacity as taxpayers, must occasionally comply with specific tax obligations. These result in the filing of tax returns, keeping of accounting and tax records, invoicing, etc.

This set of tax obligations and in particular the filing of returns require that the tax Administrations establish expeditious management and control procedures to check the completeness, formal correction and veracity of the declared data and to correct, when necessary, errors or noncompliance that is detected.

It is not possible to control the correct compliance with tax obligations in our days using exclusively tax auditing techniques, which must necessarily be selective and be geared toward detecting serious noncompliance and fighting fraud. Massive controls, developed to a good extent by computer media, constitute the appropriate procedure for all taxpayers to check compliance with their tax obligations, without affecting the existence of selective controls that allow an in-depth review by specific risk taxpayers of the degree of compliance with their obligations.

In any case, although my presentation will focus on the analysis of massive controls over tax compliance in Spain the main topic of the CIAT's 35th General Assembly is the function of examination of the Tax Administration and evasion control, I believe it is convenient to reflect on the role Tax Administrations must play in our days. This will give context to the performance of the tax control function.

In a modern and democratic society the basic objective of the Administration responsible for the management of the tax system has been necessarily furthering taxpayers' voluntary compliance with their tax obligations.

The Tax Administration cannot exclusively have a repressive and controlling profile. Our fundamental and ultimate objective is not to repress tax fraud but to prevent it from happening or, at least, reduce it to the minimum. And this objective cannot be exclusively met through coercive and punitive measures.

It is true that these measures are necessary and that it is essential to have an effective control system that allows for the detection and regularization of noncompliance cases that are detected, one that discourages future nonfilers. However, this is not enough.

Nowadays the Tax Administration must also pay special attention to the services of taxpayer information and assistance, in order to enable citizens to comply with their tax obligations. We must recognize that despite all the simplification efforts we are making, our tax systems are complex and for the average citizen, even for small- and mid-sized businessmen, taxation constitutes an arcane and an endless source of problems and concerns. Most citizens need help to prepare an income tax return, and complying with this and other tax obligations requires time and often times money. Well, we cannot ignore this reality. If we do, if we fail to assist taxpayers

meet their tax obligations, we should not be surprised if the level of voluntary compliance is unsatisfactory. It makes no sense to wait for noncompliance to take place, to later detect and correct it. What we must do is to prevent noncompliance from happening.

Consequently, we must view the taxpayer as a client, although I know this expression is somehow shocking in the tax field. But the taxpayer is entitled to receive information and assistance for complying with his tax obligations and, as we provide it to him, we will see his tax behavior will improve. In this regard we have seen that our basic objective is furthering voluntary compliance, nothing else.

In this regard, below we provide a revealing piece of information. In Spain for several years we have made a great effort to encourage most taxpayers to file their Individual Income Tax Return using computer aid programs. Nearly 90% of taxpayers use this service today. Well, the general percentage of tax returns that after being processed through computer means shows problems is 10.76%. We consider problems errors or omissions made by taxpayers, incoherence and inconsistencies detected in declared data, and the discrepancies between what has been declared and the information from other sources the Administration has. However, this percentage drops down to 7.90%, nearly 3 points below the average, when involving taxpayers who have prepared and filed their tax return using the assistance services the Tax Agency has, whether directly or through cooperating entities. Consequently, taxpayers using our citizen services not only make fewer mistakes in their returns but also file their taxes in a more truthful manner, with fewer omissions and data errors than the rest of taxpayers.

In this regard, in the last few years the Spanish Tax Agency has been submitting to requesting taxpayers, the information it has on specific revenues and income obtained by them and that must be included in their income tax return. Thus, for instance, the taxpayer is informed about the revenues from personal work they earned in the previous year and the withholding made by the payer of such revenues. This information has been previously obtained by the Tax Agency from said payer (the businessman or professional for whom the taxpayer works, or the Administration itself in case of a public official or pensioner) through the informative returns on revenues subject to withholding. Those obtaining such revenues must file such returns annually.

In addition, the taxpayer is given the available information on revenues subject to withholding which have been earned from real estate capital (for example, interest on bank accounts) or on the transfer of securities they have made.

In sum, the purpose is to inform the taxpayer before he prepares his income tax return about the information the Administration has, in order to facilitate compliance with the obligation and prevent the temptation of concealing data. This is a preventive behavior that undoubtedly will improve voluntary compliance, anticipating the possible noncompliance in the best possible manner: preventing it from happening.

In this regard, when there is evidence that some taxpayers have received income (for example, from securities issued by the State) we send them an information personalized letter indicating we are aware they have obtained such income and that they must be included when filing their income tax return. Therefore, we do not wait for the taxpayer to have the temptation to fail to comply, in hopes that we do not have information that allows for the detection of omission of certain data. We set the record straight, indicating taxpayers we know they have obtained a specific income.

I believe it is not possible to speak of massive controls without previously assessing the importance of such preventive actions and of taxpayer information and assistance services, to the extent that they encourage voluntary compliance and minimize the risk of noncompliance.

If you will allow me, to complete this vision and prior to systematically analyzing our massive control procedures, I will briefly refer to some of the initiatives we have recently adopted in Spain regarding taxpayer service. They, together with the aforementioned preventive work, have resulted in a better general compliance with tax obligations, minimizing risks and enabling authorities to focus control work on the more serious cases of noncompliance.

These are some of the most important guidelines:

- The principal tax returns can be filed using computer means. In the mid-term, it is estimated all tax processes could be done this way.

- There are aid programs in place to prepare practically all tax returns.

- Practical manuals are edited to facilitate the preparation of the principal annual tax returns (Individual Income Tax, Corporate Tax, Value Added Tax) that are sold at a nominal fee. Moreover, there are specific guidelines for the preparation or the principal tax returns that are filed with the tax return models.

- In all offices of the Spanish Tax Agency (over 300) there is an information service. In addition, comprehensive assistance services are being created to assist businessmen and professionals in the main offices. The idea is to inform businessmen of all their tax obligations in a single point, so they do not have to go to an office to pay the VAT, to another office to pay direct taxes, etc.

- There is a telephone number providing tax information, which operates 12 hours a day, with experts from each of the taxes. There is even a service for filing income tax returns by phone.

- For several years we have had automated phone units of voice recognition, which allow taxpayers to obtain information on the status of the tax refunds they have requested or to ask that identification labels be sent to them, for annexing them to the returns they must file.

- Taxpayers exempt from the obligation to file income tax returns because of the source and amount of their income, without the need to file a tax return, may request a total or partial refund of their withholdings. They may do so provided their withholdings are excessive taking into account their personal and family situation and the economic information available for Individual Income Tax Return purposes. Since they do not file a tax return, the Tax Agency is responsible for making the corresponding estimates, using the economic information it may have on those taxpayers.

- Last year we started a phone Service Center, a call sender, which does not only provide taxpayer information and assistance services but also conducts certain management

functions. Thus, when a taxpayer who is not mandated to file an income tax return requests the refund of excessive withholdings that have been made, the Center replies to said taxpayer, if his request is incomplete or fails to meet certain formalities, to resolve the problem by phone. This prevents the taxpayer from having to go to an administrative office or to have to contribute complementary documentation. Therefore, the aim is to establish a service that enables authorities to solve problems by phone, which requires investments in technology to automate the service, relate the phone system with our management and control computer applications and leave a record. This is done to have evidence on the phone conversations with taxpayers, provided they consent to their conversations being taped. In principle, the service is preferably intended for taxpayers who are exempt from the obligation to file an income tax return, but in 2001 will encompass other management and control procedures.

- The Tax Agency has a WEB page with general information, norms, queries, phones, addresses, new regulations, aid programs. The most frequently asked questions made by taxpayers and their corresponding official answers are disclosed this way.

- Since last year there is a tax current account system in place in Spain. This is an account that is completely managed by the Tax Agency without the intervention of financial entities. Said account records the amount of returns to be input or the recognized refunds in favor of businessmen or professionals who adopt this system, dealing with the V.A.T., Individual Income Tax Return, Corporate Tax, withholdings and payments on account. Therefore, taxpayers under this system do not have to input the balance resulting from their positive tax returns but only file the same so the information is recorded in their tax current account. The refunds that are recognized by the Administration are not paid directly to them either, but an accounting entry is made. The account is settled on a quarterly basis. If the result is positive, the taxpayer is informed he must pay the corresponding amount without delayed interest. If the result is negative, the Administration makes the refund of the resulting amount also without interest.

Consequently, this is a compensation mechanism for automatic tax return to be paid or refunded, which has been adopted in its initial stage of implementation by 1,200 businessmen.

- The Tax Agency participates in an inter-departmental project called Business One-Stop Window, consisting of an office where all paperwork needed to establish a company can be made. Thus, businessmen take care of tax, Social Security, municipal, commercial or industrial licenses, etc. in one single office. There are presently Windows in 10 Spanish cities and the project is in an expansion stage. In the mid-term, all these formalities will be made by way of computer technology in a Virtual One-Stop Window.

As you can see taxpayer information and assistance, as well as preventive actions, represent an authentic priority for the Spanish Tax Administration

But as I have already anticipated we must be realistic, although our basic objective is to promote voluntary compliance. We all know that noncompliance will unavoidably take place, forcing authorities to have an effective tax control system that allows for immediate detection and regularization and acts as a deterrent of future noncompliance. Like a character created by Carlos Fuentes said, *"a civilization that does not know how to defend itself is already a piece of archaeology albeit it may not know."* This statement is also valid for tax systems and organizations; either they react to noncompliance or they will be doomed to disappear.

In any case, an effective tax control system must be characterized by its flexibility and versatility.

Thus, it must be in a position to adapt itself quickly to the new socioeconomic reality in which it is immersed and the new forms of fraud and tax evasion that may emerge.

In this manner, the tax control model cannot be the same in this age of the society of information and economic globalization as in previous years. We must not keep control procedures unchanged either, ignoring such present realities in our economy as computer networks or the gradual disappearance of customs barriers between States. In addition, it is illusory to think that the fraud networks or tax engineering schemes are not permanently changing, seeking to make their tactics more difficult or prevent them from being uncovered.

For this reason we cannot talk about a closed control model but about an evolving model, one that is permanently adapting itself to the needs of the moment. In this regard, it is not enough to design in abstract an organization model and a host of control procedures for later assessing the results achieved and, depending on the results, extend or review them. It is necessary to have follow-up units and intelligence centers that, on one hand, allow learning at all times the effectiveness and efficiency of current procedures and the profitability of the adopted organization model and, on the other hand, turn our Tax Administrations into proactive entities. Such entities must be capable of anticipating events and transforming and renovating themselves, at the same pace as our socioeconomic and technological reality does.

As we will see below, this evolving concept of the control model also affects massive controls that in our days may be limited to the detection of formal and arithmetic mistakes made by taxpayers, when preparing their printed tax return, as occurred years ago.

But I said that the control model must not only be flexible and adaptable to the new reality but must also be characterized by its versatility.

In the year 2001 the tax administration, in their controlling side, must contemplate very different situations. Such situations range from the problem with a small taxpayer who files his income tax return still using printed forms and who makes merely formal mistakes and errors, to the large multinational corporation who designs in a speculative manner complex transactions to try and mask benefits. There cannot be a single checking procedure dealing with the diverse types of taxpayers whose control is our responsibility, or taking into account the different kinds of noncompliance: formal and arithmetic errors, inconsistencies and incoherence in the declared data, concealing of sales and services, transactions declared for lower-than-real amounts, tampering with deductions, use of fake invoices, creation of networks of tax fraud and evasion, etc.

In view of this reality it is necessary to define different control procedures that provide adequate answers to every kind of noncompliance, in terms of the characteristics of the taxpayer involved. Massive controls are a useful examination formula to detect and correct a good number of noncompliance cases.

However, we must not speak about a single type of massive controls but rather about different procedures involving such controls.

To zero in on the important issue and without attempting to coin the definition of the term, we can call massive controls all those computerized tax controls that allow the detection of material errors and formal mistakes made by taxpayers in filing their returns, as well as incoherence and inconsistencies in the data declared by them in comparison with the information the Tax Administration has. These controls are exclusively implemented by the Administration offices and do not cover the investigation of events or circumstances on which the Administration does not have information.

As you will see, this is a very broad concept, which allows for diverse examination procedures.

Thus, it comprises the most fundamental and traditional controls that are implemented with respect to returns filed on printed forms: corroborating they contain identification information and the signature of the interested party, review the return for completeness, include substantiating documents with the tax return. In sum, the aim is to analyze whether the return meets the minimum requirements to be deemed as filed and be incorporated into the tax computer system. Therefore, it includes previous checks to the computer process of the tax return. Evidently, should any of the aforementioned problems be detected, the taxpayer will be required to correct the mistake or provide the omitted document. This type of requirement must be met expeditiously because, lest we forget, this process involves returns that are not even ready to be included in the computerized system.

In order to expedite this process inasmuch as possible, I believe that these requirements must not undergo too many formalities. Taxpayers should be able to meet those requirements by phone, if possible.

The same holds true for formal controls applied on tax returns filed on magnetic media. In this case, the aim is to verify whether the computer support the tax return has meets the indispensable technical requirements to allow inclusion of that information in our databases. This kind of problem can be minimized if it is required that the presented computer backup has technical support, through the specific program designed to assist taxpayers in preparing the tax returns the Tax Agency distributes.

I also consider as massive controls the computerized processes that are made once the returns have been included in our databases, allowing for the detection of arithmetic errors made by the taxpayer in his return. Logically, these mistakes only occur when the taxpayer prepare the tax return on a printed form without using the corresponding computer assistance program, which would have prevented that error from happening or would have reported the existence of such irregularity, thereby preventing the return from being filed. In any case, this type of arithmetic mistake is more infrequent each time because most returns are being prepared using computer assistance programs. However, when the computerized system detects an arithmetic mistake, before reporting such error to the interested party, authorities must track down the printed form filed by the taxpayer to check whether there has really been an arithmetic mistake; not a recording mistake made by the public official who processed such return.

In the same manner, I include within the concept of massive controls the checks implemented in our computerized system to detect inconsistencies or incoherence in the data filed by the taxpayer. Such occurrences are only detected by examining the data filed without using information from other sources. Thus, it becomes impossible for a mercantile corporation to apply on the Corporate Tax the type of tax established for nonprofit foundations or entities, or for a taxpayer who declares a particular domicile to take advantage of a tax benefit for residents in a different geographical area. In these cases, this must be reported to the taxpayer so he makes whatever allegations he may deem appropriate, before authorities assess taxes making the detected error official. In this regard, our norms establish a preliminary hearing prior to the assessment, with the purpose of safeguarding taxpayers' interests. The hearing procedure may only be omitted in cases involving arithmetic mistakes made by the taxpayer, where logically he will not have anything to argue given that mathematics cannot go wrong.

Obviously, in every case, including those involving arithmetic mistakes, the assessment made by the Administration might be appealed.

The next type of massive control I will be addressing I believe is much more interesting from the standpoint of tax control. It involves the computerized checks that are made to detect discrepancies between taxpayer declared data and the information the

Administration has. This information might come from taxpayer himself, through other tax returns he has previously filed, or from third parties.

Thus, the information concerning a tax declared by a taxpayer can be verified against the information declared for another tax. For instance, authorities would try to check whether the sale price of a home declared by a taxpayer for the purpose of indirect tax assessment on the purchase is the same as that declared as basis for deductions encouraging home investments under the Individual Income Tax. They might also try to check that the volume of transactions declared by a business unit, for Value Added Tax purposes, is in line with the sales declared under the Corporate Tax and in informative returns on transactions with third parties it must file.

In addition, the information declared and included in the tax returns filed by the taxpayer can be checked, for instance, against payments on account made by businessmen and professionals.

But also the aim is to check the data declared by the taxpayer against the information the administration has from other sources.

At times, this information can be obtained directly from other public Administrations. Thus, if another Ministry grants subsidies and government aid to companies for the conduct of their activities or to individuals for giving them access to housing, and provided these subsidies and aid constitute tax income, the Ministry granting such assistance must inform the tax administration the identity of the beneficiaries of subsidies and assistance, and the amount each of them received.

However, in most cases, information from third parties is obtained from informative tax returns. In Spain this information has a fundamental importance for the management and control of the tax system.

Consequently, all taxpaying entities who make withholding payments are obliged to file an annual summarized return, identifying separately the earners of such income. They must report this information to the Tax Agency along with the amounts the taxpayers earned and the withholdings that have been made. Therefore, the obligations of the withholding agent are not limited to making tax

payments on account of taxpayers. They are also obliged to file an annual informative return.

In Spain there are the following informative returns on income subject to withholding:

- Income from personal work as well as professional, agricultural, cattle-raising, forestry activities and awards.

- Income from real estate capital, making a differentiation between implicit income, bank account interest, capitalization operations and insurance or disability insurance contracts, and the remaining incomes.

- Income from the lease of specific urban real estate.

- Transmission and reimbursement of titles from collective investment institutions.

The amount of information obtained from these returns is extraordinary. Therefore, the timely and accurate filing of those returns is one of the priorities of our organization. We must bear in mind that compliance with these obligations represents a management cost for affected taxpayers, requiring an additional effort from the Tax Agency. The Agency must prepare and distribute computer aid programs for the preparation of different returns, conduct information campaigns and dissemination sessions on the norms that are passed and, in sum, step up its efforts in the area of taxpayer information and assistance and regarding preventive actions. This will enable authorities to effectively manage and control our tax system using quality information obtained from third parties.

But in Spain there are not only informative returns on income subject to withholding but also other informative returns of varied nature. The principal such returns are:

- Annual description of individuals or companies with which transactions in excess of 500,000 pesetas were held during the preceding fiscal year.

- Description of businessmen or intra-community asset purchases. This informative return is filed quarterly by most V.A.T. taxpayers required to file it.

- Annual summarized return of subsidies or compensations delivered or given to farmers and cattlemen.
- Annual return of participants and contributors of Plans, Pension Funds and Social Security Entities.
- Annual return of operations inspected by public officials and other financial intermediaries.
- Annual return on magnetic media of operations with Treasury Bills, account annotations, intervention in management entities, and the Annotations Central Office.
- Annual return of mortgage loans granted for the purchase of housing.
- Annual return of donations received provided that they grant the donor the right to deduct from the Individual Income Tax.
- Annual return on magnetic media of shares or capital or asset representation share in collective investment institutions

The aforementioned is important to highlight the importance of annual returns on income subject to withholding and the efforts required regarding taxpayer information and assistance as well as other informative returns. In any case, the workload they pose for the Tax Agency forces them to prioritize their actions. For example, for us it is more important that large financial entities file their returns on income from real estate capital subject to withholding or that a large company with thousands of employees meet correctly the obligation to file the annual return of personal work income. This is more important than the problems and issues that may come up regarding informative donation returns filed by small nonprofit entities.

Additionally, not every piece of information obtained from informative returns is exploited in the same manner.

Consequently, there are returns, such as the annual income of personal work subject to withholding, that are exploited in an exhaustive and systematic manner. Said annual income allows us to corroborate that the taxpayers who declare personal work income for the Individual Income Tax do so correctly. This also allows us to

detect taxpayers who have not filed such return, despite their obligation to do so. We have information on practically 20 million earned of such type of income.

We cannot conclude, however, that in every case where there is a discrepancy between declared work income for Income Tax and the information supplied by the businessman for whom he works, a provisional assessment should be made without further investigations. The purpose of this would be correcting the inconsistency detected.

At times, the mistake has been made by the businessman when preparing the informative return or by the Tax Agency itself when processing such return on computer. Because of this, in compliance with the hearing procedure after the discrepancy has been detected, a formal notification is sent to the taxpayer requesting a clarification. The taxpayer is further warned that should he fail to clarify this matter, a tax assessment will be made.

During the hearing procedure, the taxpayer may justify the correction of the declared data providing the corresponding certificate issued by the businessman, establishing necessarily the income earned and the withholding made. This certificate must be sent to the taxpayer by the businessman prior to the beginning of the term for submitting the tax return, in accordance with the provisions of our internal norms. On the other hand, the taxpayer may admit he made a mistake, in which case he will be notified of the resulting assessment. Moreover, there may be doubts on the authenticity of the certificate presented by the taxpayer; it may not be sufficiently explicit or simply the taxpayer does not have one. In these cases, the Tax Agency, prior to assessing taxes, requests the withholding businessman to confirm the data for a specific taxpayer he presented in his informative return because it may come from a mistake in the return preparation and not from an attempt to conceal income from the taxpayer.

The situation is not exactly the same when the discrepancy deals with income from real estate assets. In this case, what often happens is that the bank account is in the name of the spouse, who appears as income earner in the informative return submitted by the financial entity. In reality, it involves a joint account of both spouses. Logically, these cases can only be solved using the hearing procedure.

On other occasions, the reliability of the information included in informative returns is questionable, which goes against its systematic exploitation. This is what often occurs with informative returns on donations that are filed by nonprofit entities, in general entities with a reduced administrative infrastructure and little tax culture. For this reason, frequently there are discrepancies between deductions for donations made by taxpayers and the information thereof obtained from the aforementioned informative return.

This limitation suggests that the taxpayer be required to justify the discrepancy when the deducted amount is significant or the amount he declared having donated is high compared with his level of income. It is appropriate to question the taxpayer for this only when there are additional reasons, such as the existence of discrepancies concerning personal work income he declared.

In other cases, the information obtained from informative returns does not enable authorities to quantify the amount of the detected discrepancy. This happens when there is evidence that a taxpayer has sold securities but has not declared any profits or increase in capital. Logically, he should have declared profits or an increase in capital, if the sale actually took place. Nonetheless, the Administration is only aware of the sale value of securities but does not know the amount of capital gain or loss, which can only be estimated using the sale price of securities and the fiscal year or years in which they were purchased.

For this reason, the information the administration has is partial and actions must be prioritized, applying risk and administrative efficiency criteria. The taxpayer must be inquired only in most significant cases. When action is taken, taxpayers will be requested to provide all necessary documentation to estimate the possible capital gain or loss. In view of the documentation provided, the administration will be in a position, if the discrepancy is confirmed, of estimating the undeclared capital gain or loss, at which time the hearing procedure may be instituted. Therefore, in these cases, the examination procedure is somehow more complex.

On other occasions, the information the administration has may be incomplete or limited, which requires the adoption of certain caveats. This occurs with the information included in the annual informative return of transactions with third parties. By way of this return businessmen or professionals report their sales and purchases of goods and services in excess of 500,000 pesetas to the administration.

However, small businessmen who apply objective taxation regimes are exempt from filing this return and such return does not include operations for which it is not necessary to issue a complete invoice (for instance, retail sales).

Thus, if a businessman declared sales for 10 million pesetas for the purpose of filing the Corporate Tax and the Value Added Tax, while his business clients declared making purchases from him for 11 million pesetas in their informative returns, the doubt arises on the convenience to purge and settle the discrepancy detected without further consideration, accepting the 1-million pesetas difference.

If we act in this manner, it may be that the concealed volume of sales may be higher than the 1-million peseta discrepancy detected. As has been indicated, no transactions for less than 500,000 pesetas or retail sales are included in the third party transaction returns. There are specific exemption rules for the annotation of certain transactions made applying objective regimes of taxation.

In view of this situation, it is probably more appropriate to use the available information as taxpayer selection criterion for the purpose of a tax audit, rather than directly exploiting such information in the course of a thorough examination.

So far we have seen different cases in which massive control actions are made taking into account only the formal defects detected in the return or the taxpayer-supplied or third party-supplied information the Administration has. However, in my opinion, massive controls can be extended to other cases.

For example, when the taxpayer makes a juridical-tax mistake in his return. This would be the case of a Value Added Tax taxpayer who engages in an activity that does not give rise to payment deductions and that, nevertheless, requests a refund for such tax.

Also in the cases where the declared data are inconsistent or illogical, for instance, when a taxpayer engaged in business or professional activities declares losses for various consecutive years for the Individual Income Tax, without having other significant sources of income. One may consider selecting this taxpayer for an in-depth tax audit. However, examination actions are necessarily selective and we do not have limited resources to initiate and develop this kind of action. In addition, the taxpayer normally requests a refund

for which we have a maximum six-month term to make our decision, in accordance with internal norms. From that moment on, delayed interest is generated in favor of the taxpayer with the ensuing added cost for the Administration.

In view of situations such as this, in the course of massive controls carried out in the campaign of examination of Individual Income Tax returns, the Spanish Tax Agency requires that the taxpayer-businessman present the tax books and records for the Individual Income Tax returns he must necessarily maintain. An exception applies is such taxpayer is mandated by tax law to keep commercial accounting records instead of the aforementioned books. This is done prior to making the corresponding decision: Make the requested refund if his return is correct (the negative result may come from significant investments in the activity), make a provisional tax assessment following the hearing procedure. Such refund is denied if it is not justified based on the declared figures. On the other hand, the case file is transferred to examination entities that are responsible for tax audits in Spain, if authorities conclude the examined return involves nothing but an act of noncompliance of his tax obligations on the part of the taxpayer.

This way of doing business means employing risk analysis techniques in massive checks in order to prevent that inconsistent or unreliable returns not be reviewed. Such returns cannot be selected directly for in-depth review by examination entities, taking into account the number of actions they may undertake is always limited.

Since this type of specialized massive control action with the application of risk analysis techniques cannot be carried out broadly in Spain, we have geared our efforts fundamentally toward returns requesting tax refunds and those cases where the taxpayer-businessman does not have an obligation to maintain accounting records in accordance with the Commerce Code and business regulations. Accounting must be kept using tax records and books whose examination is less complex than the accounting.

Up to this point, I will review the examination actions we deem massive controls in Spain. Below I will be addressing some organizational and procedural decisions we have adopted in this regard, which can serve as basis for exchanging views with representatives of other States.

However, I believe it is time to make a critical assessment of the rile massive controls play out in our tax systems.

I believe some of the advantages of these examination procedures are quite evident.

In the first place, this involves highly computerized procedures with a lower cost in human resources than necessary to deal with more selective examinations.

Moreover, its massive character is the best guarantee of homogeneity in the application of the same criteria and procedures throughout the territory. To this contributes the existence of Manuals that govern actions and establish what communication models are used in each case to inquire the taxpayer, send him the tax assessment proposal to resolve the hearing procedure, and, if applicable, make a provisional tax assessment.

Additionally, it involves a control system that is extraordinarily effective. In the year 2000 the Tax Agency made assessments using massive procedures for approximately 300,000 million pesetas. This included not only assessments to be entered but also assessments denying or reducing refunds requested by taxpayers. Of said amount, 50,000 million are for tax assessments for large companies and the rest for other types of taxpayers. This high effectiveness, combined with the low cost of actions, constitutes a good example of the efficiency. This principle must inspire the actions of tax organizations, which must of course achieve important quantitative results in the control and struggle against fraud. However, they must also be an example of austerity and profitability in the use of public resources.

On the other hand, massive controls generate an undeniable direct effect, viewed as the immediate correction of noncompliance detected with the ensuing receipt of the owed amount. Thus, the percentage of collections in voluntary period of tax debts resulting from these control actions is very high. There are two reasons for this. In the first place, the immediate nature of the actions, which normally deals with the last filed returns and, secondly, and directly related to this, the reduced average amount of most corrective actions carried out and easy acceptance by the taxpayer at fault. In this regard, it must be taken into account that in many cases the tax assessment made is limited to demanding the delayed interest

on unpaid amounts, but does not give rise to the opening of a penalty case file. The latter will only occur if inexcusable guilt or negligence in taxpayer's behavior is observed.

The direct effect of actions is complemented by the strong deferred effect they produce. In this manner, the taxpayer who undergoes corrective actions displays greater caution and responsibility in future occasions and his degree of voluntary compliance in the future improves significantly.

The indisputable effect generated by massive control actions must also be considered, to the extent that every year they cover a large number of taxpayers. This conveys to society at large an evident feeling of control from the Tax Agency, which contributes decisively to deter taxpayers from failing to comply in the future. The examination actions, because of their selective nature, are not enough to ensure the presence of the Tax Administration in society and generate the desired effect. Nonetheless, they are viewed as imposing exemplary sanctions.

On the other hand, massive controls serve as an effective instrument of taxpayer selection to be closely examined by examination entities. In sum, this involves thousands of actions started every year, in the course of which authorities may appreciate events and discover signs and indications that reveal acts of noncompliance with tax obligations have been committed, more serious and widespread than initially detected. In this case, examination entities must continue the control actions.

But I said I wanted to make a critical assessment of these control procedures and so far I have only explained their advantages. The time has come for me to refer to the limitations of control procedures and the problems their implementation can generate.

Their first limitation is evident: these massive procedures allow the correction of formal or minor acts of noncompliance. At times, they may serve as a taxpayer pre-selection instrument to check their tax situation in-depth. However, massive procedures alone do not guarantee sufficient controls over the tax system and, evidently, they do not serve to detect and repress serious cases of noncompliance and tax fraud networks.

For this reason, it is indispensable to complement massive controls with selective tax audit actions and lines of investigation specialized in the detection of fraud networks and underground economy

activities. I am not going to address this type of controls; this is not the purpose of my presentation. I simply want to reiterate I am convinced that our control model must be flexible and versatile, with a permanent ability to adapt itself to the socioeconomic and technological reality it is immersed in. Just as matter of example, I would dare say that the present and immediate future lie with electronic commerce and the internationalization of the economy. The tax Administrations must have a clear control strategy in the face of these new realities and train specialists who guarantee that our organizations and procedures are brought up to date. But this is not the moment to address those issues.

As I was saying, massive controls are indispensable but by themselves are not enough and must be complemented with selective controls and tax investigation actions, in the context of an evolving and proactive tax control model.

However, there is another limitation this type of controls have, which I do not want to ignore. I referred above to a broad set of examination procedures that may be considered massive controls, however, some of them, precisely those most specialized and interesting from the standpoint of detection of serious cases of noncompliance, cannot be applied in a general and indiscriminate manner.

Thus, there is no obstacle preventing the tax returns from being subject to mere formal controls that guarantee their completeness and computer processes that detect arithmetic mistakes made by the taxpayer. However, it does not seem possible to examine all returns for which discrepancies are found between declared data and information from other sources the Administration has.

We have already seen that the quality and reliability of the information the Administration has from informative returns is not standardized. We have seen that there are procedures such as the discrepancy resolution procedure for income from real estate assets, in which it is difficult to attribute beforehand income to a specific taxpayer. This is because of juridical problems on the ownership of the bank account or the financial product involved. We have already seen that on some occasions massive controls incorporate risk analysis techniques to detect inconsistent or illogical returns, normally related to business or professional activities.

In all these cases, characterized by a certain degree of complexity, massive controls, despite being too general, must be prioritized applying criteria of efficiency and risk analysis. This must be done in view of the Administration's inability to initiate an unlimited number of actions.

Therefore, in a large number of cases massive controls must also be implemented using selective criteria, not as detailed as in examination actions. Undoubtedly, they force authorities to establish efficient systems of planning, selection, and follow-up of actions and results that are obtained. The purpose of this is to be as efficient as possible and to plan and select future actions appropriately.

Another problem I want to address is the ability to predict massive examination actions, which can bring about the appearance of what we call a factor of control procedure exhaustion. Indeed, these computerized control are highly effective at the time of being implemented, but in a few years taxpayers, and in particular their tax advisers, are aware of the fact that the computer control programs of the tax Administration unavoidably detect specific errors, omissions and acts of noncompliance. In view of this situation, he who plans to commit fraud may know in which cases the risk of being found is greater. Therefore, he will carry out other noncompliance formulas and subterfuges, the utilization of which is not systematically controlled by the Administration. For this reason, it is appropriate to frequently review the present and historic profitability of all examination procedures to modify immediately those that show signs of exhaustion. Consequently, the incorporation of new crosschecks of computer information, the modification of the quantitative limits that determine the beginning of examination actions and the permanent review of procedures have become indispensable.

Another interesting thing to be dealt with is the interrelationship between massive control procedures and in-depth examinations, in particular to the extent that the procedures grow more sophisticated and complex and deal with business or professional activities. Such activities constitute the preferred center of attention of examination actions and in-depth tax audits.

In view of this situation I must clarify that in Spain all tax assessments that are made in the conduct of massive control actions are provisional.

Consequently, they can in no way prevent or hinder that the taxpayer be examined at a later time. It is true that in keeping with the principle of juridical security and the doctrine of administrative actions, in the course of an examination authorities will not be able to review the juridical evaluation and assessments of massive control examinations once again. As the old Latin saying goes, venire contra factum proprium non valet. Nobody can go against his own actions, not even the Administration.

This does not mean that the tax concept and tax period already reviewed cannot be examined in depth. Simply, on the second opportunity control actions must deal with issues that have not yet been analyzed. They will eventually become the majority taking into account that massive control will have dealt with some piece of information or specific aspect and that massive control actions are entirely carried out by the tax Administration offices. As a result, they have an exclusively documentary nature, so at no point in time will financial flows associated with operations dealing with the physical reality of events be reviewed.

In conclusion, massive controls for the formal and documentary examination of a specific tax return, normally the last one filed, do not prevent future in-depth examinations that may even deal with the tax concept and tax period already checked. Massive controls are not designed to review the general tax situation of the taxpayer, without competence limitations or restriction on means of examination.

Logically, the planning and execution of one and another type of examination must be made in a coordinated fashion to prevent, inasmuch as possible, duplications and unnecessary bothers to the taxpayer.

Therefore, massive controls are highly effective and give indisputable advantages to the Administration. However, we must be aware of its limitations and include it in an overall tax control strategy, which requires its full coordination with other tax examination procedures.

In this context, I want to refer now to some organizational and procedural decisions we have adopted in Spain with regard to the massive control procedures and that may serve to compare opinions in the ensuing debate.

All I have presented so far deals basically with the examination procedure for annual returns of Individual Income Tax, Corporate Tax and Value Added Tax. It is, to a good extent, applicable to the monthly V.A.T returns taxpayers registered with the Registry of Exports and other Economic Operators file, as well as other instantaneous income tax returns, such as the Special Tax on Specific Means of Transportation.

However, the monthly or quarterly returns that are filed by taxpayers subject to income tax withholding, the payments on account for the corresponding annual return businessmen or professionals must file and monthly or quarterly V.A.T. returns, are subject to a specific and distinct examination procedure.

All of the returns I just mentioned have two common characteristics: they are filed by businessmen, professionals and withholding parties, that is, by qualified taxpayers, and are periodical returns subordinated to an annual return that will be later subjected to the massive controls I have already described.

Consequently, the degree of intensity of the control of these periodical returns does not seem to be the same as the one applied in relation to annual returns. We must at least recognize that in view of the inability to examine all returns, efficiency reasons suggest that we intensify control actions regarding annual returns rather than those filed at shorter intervals and which come under the annual tax returns.

Nevertheless, as I have already said, the aforementioned periodical returns are subject to a specific control procedure. In this case, the Tax Agency only corroborates that the taxpayer mandated to file a tax return of this kind (monthly or quarterly V.A.T., installments or withholdings) has indeed done so. To that end, it exchanges census information the Administration has on those qualified taxpayers, because we must not forget they are businessmen, professionals and withholding agents, with the fiche of self-assessments filed through collaborating entities that receive such tax returns. Beginning a few years ago, information is also exchanged, logically, with the fiche of tax returns filed through computer means.

Moreover, when the omission of a tax return is detected, the alleged nonfiler is asked to immediately file such returns or, if necessary, file a census return informing the Administration the reason forcing him not to file the omitted tax return

Therefore, this is a computerized control procedure that allows the detection of omission in the filing of this type of returns. Since all processes are subject to a permanent process of evolution to prevent taxpayers with fraudulent intentions from accommodating their conduct in terms of the expectations of being examined, this procedure was modified very recently because we learned of cases where the fraudulent taxpayer only filed returns for symbolic amounts. He knew the risk he assumed if he failed to file his return in light of the initial design of this procedure.

In view of this situation, we set a level of reference or amount expected for each taxpayer and type of return. To that end, we used historical information on his tax behavior in the last fiscal year and, if needed, the result of control actions he would have recently undergone. In this manner, we began to inquire not only absolute nonfilers, that is, those who fail to file their due return, but also relative nonfilers. The latter file periodic returns for amounts significantly less than those of the corresponding level of reference.

However, when the absolute or relative nonfiler ignores the Agency's notification, the only possibility we have is sending their case file to Examination entities to be audited applying tax audit techniques.

In this regard, the application of massive control procedures does not apply because the Administration does not have information from third parties, which will enable it to make the corresponding assessment. Said information is obtained from the filing of annual informative returns still not filed when the filing of monthly or quarterly returns for the corresponding fiscal year are being reviewed.

In this regard, from the juridical standpoint, the level of historical reference estimated considering the taxes paid by the taxpayer in the last fiscal year, is not considered sufficient evidence to base the corresponding tax assessment. For this reason, in case the notification is ignored, if there are enough grounds for this case, it is submitted to the Examination entities for the continuation of actions applying tax audit techniques.

Returns of Special Manufacturing Taxes are also subject to specific controls: hydrocarbons, tobacco work, alcoholic and other beverages, and beer. In these cases, their special nature is given by the entity that develops control actions because examinations are made by the services of the Department of Customs and Special Taxes.

Another important organizational decision has been the creation of specialized management and massive control Units for large companies. In Spain falling in this category are those companies whose annual sales exceed 1,000 million pesetas. They are 19,000 taxpayers who practically pay half of our country's tax revenues, so the justification for the creation of these specialized units is evident: conducting permanent follow-up of their tax behavior and facilitate to the aforementioned companies a specific and direct channel of communication with the Administration. There is a Central Unit that monitors the biggest Spanish companies and 17 Regional Units that monitor the rest using geographical criteria. Although their function is to exert management and massive control duties, these Units come organically and functionally under the Department of Financial and Tax Examination, that is, the management entity in charge of tax examination and audit. The reason for this is ensuring the best possible coordination of all actions dealing with these important and qualified taxpayers.

Important organizational modifications were also adopted in 1994 for small taxpayers, on the opposite end. Given that they are small businessmen who apply objective taxation regimes, it makes no sense to have different entities perform massive controls and examinations. For this reason, specialized Units were created and tasked with the management and comprehensive control over these small businessmen, whose number in Spain is very large, 1,900,000 businessmen. They account for approximately half of our census of businessmen and professionals.

The main characteristic of the control model for small taxpayers is that it is based on making frequent visits to their workplaces. Such visits have a comprehensive nature, that is, they are not only limited to examining that taxpayers comply with their tax obligations. Rather, such visits serve to provide information and assistance to the taxpayers on those obligations and the new norms affecting them. These visits enable authorities to gather data that can later be exploited in the control of taxpayers' returns and to verify their census situation.

We have also created specialized massive control units for taxpayers with specific characteristics. Thus, we have units responsible for monitoring V.A.T. taxpayers listed in the Registry of Exporters and Other Economic Operators and for the management and control of nonresident taxpayers. However, this type of unit only exists in particular geographical areas.

In the same manner, we are creating specialized examination and control units, who will be responsible for complex audits in the field of massive controls, such as the review of tax books and records. This will facilitate the specialization of officials, improved efficiency in actions and coordination with Examination entities.

But organizational reforms cannot be limited to operating entities. We have already seen that there is a large diversity of taxpayers, each with their own problems. We have seen that the types of noncompliance and necessary control procedures for their detection and correction are varied. It is becoming increasingly necessary to have new control entities with a high degree of specialization. An effective control strategy cannot be conceived without meeting the needs of information and assistance of taxpayers and without devoting special attention to preventive actions. This takes place in a changing socioeconomic and technological atmosphere.

In this context, to effectively carry out the complicated function of management and tax system control tasked upon us by society, I believe that the work of direction, planning, coordination and follow-up is essential. We cannot limit ourselves to designing a series of procedures and to create different entities for their implementation, for making a balance of results and demand responsibilities at the end of the year.

Tax organizations of the XXI century and necessarily complex and we have already seen they must evolve at the same pace as society and the economy does. To that end, the management function is indispensable.

Below, I want to refer to some decisions adopted by the Spanish Tax Agency in the last few years to strengthen the management function and to guarantee the internal coordination of the organization and its permanent adaptation to reality:

- There is a Permanent Management Committee that meets every week. It consists of Directors from different functional Departments and the Services of the Tax Agency.
- The Territorial Management Committee meets on a monthly basis; such meetings are attended by the members of the Permanent Management Committee and those responsible for territorial services of the Tax Agency.

- The Tax Agency has an Internal Auditing service, an internal control entity that in addition to investigating possible irregularities, reviews permanently the management and control procedures, the way in which they are implemented and the results obtained. It does so to propose modifications and improvements.

- There is a Department of Organization, Planning and Institutional Relations that, among other functions, coordinates the instruments of planning the Tax Agency has.

- All control actions are carried out in accordance with general principles and criteria included in a multi-annual Tax Control Management Program and are implemented in Annual Control Plans. These Plans contain the general directives to be following during the fiscal year, Partial Management Plans (massive control), Examination (tax audit) and Customs and Special Taxes. In addition, they establish coordination and integration norms among the different Partial Plans.

- Every year the Tax Agency establishes a Plan of Objectives, outlining the commitments to be fulfilled by the organization as a whole and by each of its functional areas and territorial services. The objectives deal with both control results and procedural improvements, such as the reduction of processing time for making requested refunds or the appeals filed by taxpayers against administrative actions.

- Since last year the Tax Agency has a Special Quality Program, also annual, where the organization outlines different qualitative objectives. In this regard, in the area of massive control, it is not enough to apply procedures and fulfill the minimum number of actions established in the Control Plan. It is not enough either to attain the expected tax assessment results in the Plan of Objectives. On the contrary, it is necessary to attain its goals observing minimum standards of quality. Thus, the percentage of reviewed problematic tax returns is analyzed, along with the collection rate in the tax assessment voluntary period, legal disputes thereof, percentage of taxpayers who comply in the voluntary period, etc.

- The Tax Agency has a National Fraud Investigation Office, the purpose of which goes beyond the detection and repression of fraud networks and underground economy. It is tasked with study and analysis work. Thus, at this time it is, among other things, responsible for designing and implementing the strategy of the organization in the face of the significant increase of electronic commerce in our society. It is also responsible for the analysis of the impact of the elimination of customs and tax barriers in the European Union and its tax consequences. In sum, the aim is to have an intelligence center that allows the Tax Agency to anticipate events by acting in a proactive manner.

- More directly related to massive control, there is a Team of Study and Analysis at the National Tax Management Office, the main purpose of which is to value the effect massive controls have over taxpayers voluntary compliance and, if necessary, further their modification. This is done to bring them in line with the new economic reality and prevent taxpayers behavior from accommodating to the design of control procedures.

Finally, I want to take this opportunity to ask all States that are present to commit themselves inasmuch as possible with the struggle against tax fraud and evasion. To achieve this, it is indispensable that we strengthen international cooperation and mutual assistance mechanisms.

In the age of the society of information, economic globalization and the internationalization of the economy, it is a mistake to think of the struggle against fraud in a separated manner as a problem of each State.

We must devise cooperation mechanisms that are more automatic each time. This will enable us in the future to make massive and regular sending of significant tax information to other State the customary practice. In the medium term, this information from other States should be so frequent and generalized that it may be exploited systematically by massive tax control procedures, similar to those I mentioned in my presentation.

In this regard, I do not think there may be restrictions or mental reservations by any State. The struggle against fraud is a problem

of justice, without national or political connotations, unless we think like Robespierre that there are only two parties, that of the good and that of bad citizens.

I believe the time to wrap things up is approaching.

In Spain, as you have seen, massive controls have an enormous importance. However, we conduct all examination actions in a clearly defined strategy: our basic objective is furthering voluntary compliance of tax obligations by taxpayers, none other. Both taxpayer information and assistance services and control actions contribute to this strategy. We cannot only base our actions only on coercive and repressive strategies. Providing assistance to citizens in fulfilling their tax obligations and preventive actions are a priority for us.

Now matter how big are our efforts regarding taxpayer service, acts of noncompliance will continue to take place inevitably. The tax awareness of citizens improves but there is still a long way to go in thinking of an idyllic society with full voluntary compliance with tax obligations. That would be the dream of history, paraphrasing the title of a novel by Jorge Edwards. Meanwhile, tax control systems are indispensable.

And in this regard, massive controls, with their computer support, and the massive exploitation of information the Administration has are extraordinarily effective but are not enough to guarantee correct tax compliance. There must also be effective in-depth controls, which are duly coordinated with massive controls. The control model as a whole must be an open and evolving model, one that is permanently adapting itself to the new socioeconomic reality. To that end, it is essential that our tax organizations act in a proactive fashion, anticipating events.

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Case study:

TOPIC 2.1

THE PROCESSING OF TAX RETURNS FOR DETECTING ERRORS, INCONSISTENCIES AND OMISSIONS

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1. INTRODUCTION

1.1 Outline

The Tax Administration must oversee taxpayer's actions, guard the correct payment of taxes and fight against tax evasion.

Examination processes comprise a group of tasks that have as a purpose to achieve tax compliance on behalf of taxpayers, by providing equal and permanent signs in the examination of taxes.

This examination is done through massive and selective processes that act in a complementary manner in the taxpayer's review process. The former have great coverage for the examination of taxpayers, ideally the complete universe thereof, and the latter are directed to specific segments considered as high-risk. This document is directed to analyze massive examination processes, which are operating in the Chilean Tax Administration.

Current technology must support all processes carried out to examine the universe of taxpayers, that is, from collecting information, computer examination, determination of taxpayers with problems, up to the attention of taxpayers at the Operative Units. In the Chilean case, the main advances have been carried out in structured and massive information processes, mainly in the Income Operation, where through cross checks and algorithms, a selection of taxpayers to be examined in detail with high levels of assertiveness is performed.

In parallel with this potentiality regarding the availability and to the use of massive information, tremendous efforts have been carried out to generalize the use of Internet for the filing of taxpayers' returns, informing agents and inquiries regarding the state and the results of the processes that affect taxpayers.

1.2. Massive Examination Processes.

Massive examination processes have as a purpose to control the complete universe of taxpayers of a determinate tax to select those that do not comply with their tax obligations and/or that their returns present inconsistencies.

Mainly there are two types of sworn income tax returns, which pertain to the Declaration of the VAT and the Income Tax Return.

a) VAT is filed through a Monthly Simultaneous Declaration and Payment Form, which is filed monthly, and approximately one million returns are filed. In this type of declaration the taxpayer informs on the internal, external, encumbered and/or exempted

sales performed, the debits and credits of value added tax and additional taxes. During the fiscal year, withholding on third parties' income are carried out as well as provisional payments on account of the Income Tax, which are also declared and paid through the same form.

b) In the case of Income Tax Returns, every year during the month of April, around 1.9 million are received. On this occasion natural persons and companies perform their Income Tax Return through a single form intended for these purposes. In the event that withholdings and provisional payments introduced through the Monthly Simultaneous Declaration and Payment Form surpass the amount to be effectively paid, the Tax Administration returns the surplus to the taxpayer in a one to two month term as from the date on which the tax return is filed.

Massive processes are implemented on the basis of structured rules, which verify logic - tax compliance, they are applied to all taxpayers and guarantee impartiality in the selection process of objected taxpayers. On the other hand, the intense use of information technologies allows the generation of high-frequency processes for a tax term, several times throughout the year for Income Tax and at least once a month for monthly taxes such as the VAT.

Actions of this nature, due to their high coverage, causes an important indirect compliance effect, since it induces in the taxpayer universe the perception of control.

The main stages of the massive process are the generation of observed tax returns, selection of objected taxpayers, workload scheduling and later attention at the offices, generation of notices, control of inconsistencies, collection of differences and the treatment thereof, and lastly periodical and structured statistics are obtained, which allow to take control of these processes, in addition to allowing a better and greater learning from the same.

External Cross Check Operation processes, VAT and Revenue, are structured as dynamic industrial processes, which are done centrally, where stages as those mentioned the foregoing paragraph have been defined, with input parameters common to all returns of one type of tax, conversion processes and outputs.

The filing of returns through the Internet is done through an on-screen form or through software, which validates the logical - mathematical quadrature of the return, allows to eliminate discrepancies that are the product of easily detected mistakes and correction in the preparation of the returns, effectively focusing examination towards correct tax compliance. The correction of returns through Internet, also prevents the taxpayer from appearing before the offices to correct formal mistakes. In this manner, the Tax Administration tends towards the more efficient assignment of examination resources for cases that require a more in-depth analysis of the inconsistencies detected.

To carry out these processes, the Tax Administration, must have technological and management systems that allow to provide support to all stages of the massive process with the quality and timeliness required.

1.3 Guidelines

The Chilean Tax Administration efforts are framed in broad guidelines regarding the processing of returns:

a) To have an information reception, digitizing and processing model, which complies with the terms established and, that is efficient and homogeneous in the treatment of return.

b) To improve the assertiveness of the control algorithms defined for taxes.

c) To have procedures that facilitate the operation for taxpayers that sec to comply with their tax obligations.

d) To put at the taxpayer's disposition support software for the preparation of returns, avoiding arithmetical or validation mistakes.

e) To put at the taxpayer's disposition, through the Internet, the information that the Tax Administration has to avoid mistakes in the preparation of the returns and to advance on a transparency policy.

f) To allow the self-attention through Internet for the solution of most inconsistencies.

2. CHILEAN MODEL OF MASSIVE EXAMINATION PROCESSES

In the Chilean Tax Administration massive examination processes present a general process structure as it may be seen and described hereinafter:

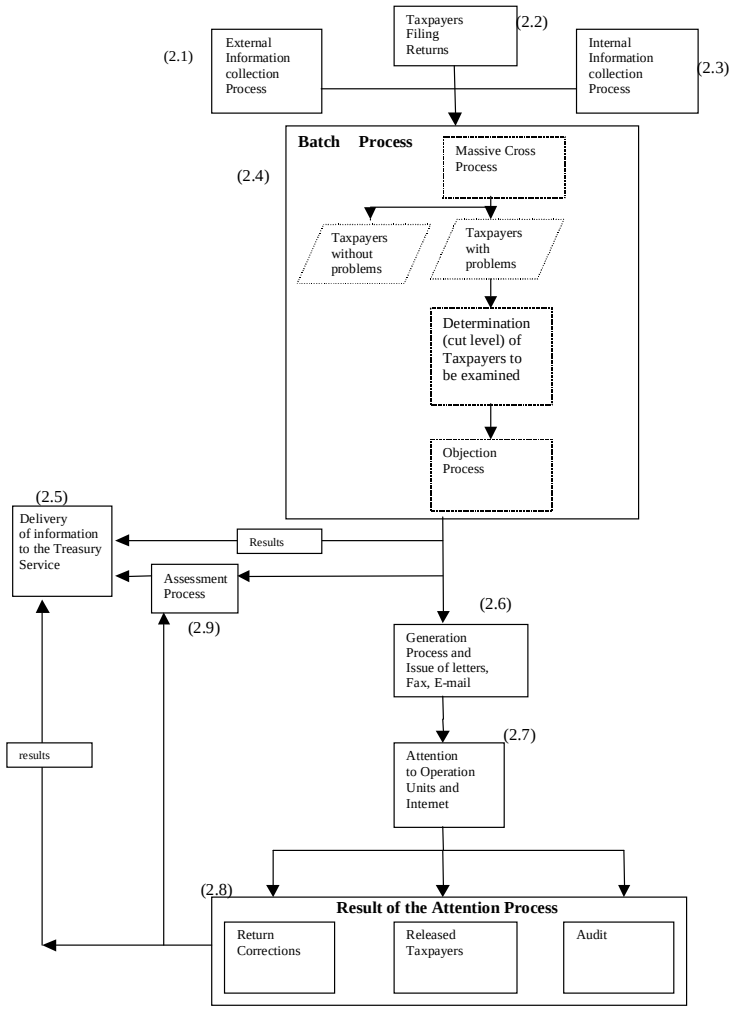


Figure Nº1: Massive Processes Model

In Figure Nº1 we can appreciate that for the development of the massive examination process three elements that are related in their execution converge, determining there from the selection of taxpayers to be notified: the information delivered by external agents, returns filed by taxpayers and observations that allow to establish inconsistencies or the level of tax default.

2.1 External Information Collection

Information filed by External Agents, through sworn tax returns, constitutes information additional to the Income Tax Return, the same is collected prior to the taxpayers' returns and is used to compare what appears registered in the returns thereof. This information is delivered each year by public and private institutions such as Employers, Social Security Institutions, Investment Funds Managers, Companies, Banks, Corporations, Civil Registry. In these sworn tax returns information is provided on revenue, tax withholding, interests accrued from investments or other actions with tax impacts performed by the taxpayers during the previous year. This information is used in the Income Operation Process to determine possible inconsistencies with what has been filed by taxpayers.

2.2 Filing Returns

The Chilean Tax system establishes a tax return system where the taxpayer is responsible of determining his taxable base and the amount to be paid. Returns of this type have the nature of sworn income tax returns, therefore the taxpayer must be answerable for the truthfulness and validity of the information that he declares. Returns filed by taxpayers constitute the base on which the process shall be executed, there are intra-return cross checks that determine objections due to differences in the form, inter-return cross checks such as the analysis of the tax consistency filed by the taxpayer in time and external information cross checks to the return.

In the case of Income Operation 2001 the taxpayer shall be presented with a proposal of his return pursuant to the information that the Tax Administration has available.

2.3 Internal Information Collection

Information generated by the Tax Administration as from its own data, constitutes internal information, these are the lists of taxpayers that present any particular restriction or that are protected under any tax franchise that constitutes complementation information sources for comparison.

2.4 Massive Audit or Batch Process

The massive cross checking of returns use the aforementioned elements and are performed through software that performs a standard analysis through structured algorithms called Observations.

Observations

Observations are a group of structured rules that relate the contents of the return with external information, establishing formal, arithmetic and tax consistency rules.

Formal observations are directed to verify the form aspects of the return, such as the identification, activity codes and domicile[1].

Quadrature observations are directed to verify the arithmetic consistency of the return, by verifying the determination of taxable base, rate application and the correct determination of reductions and balances.

Tax observations are directed to verify the tax consistencies of the return and make an extensive use of external information, by reviewing the underfiling of income, credit surpluses and origin thereof, or the failure to comply with the obligation to file a income tax return.

As from Massive Auditing the universe of returns is segmented between those that do not present observations and those that contain some kind of inconsistency with the information available from the Service.

Default Matrix

The file of returns observed appears in a matrix, which allows to classify these returns in default zones with various levels seriousness. This is a double entry matrix, where the rows represent the different observations, and the columns of default levels for each one of them. Default levels are measured in terms of the amounts of discrepancies that the return has when compared with the different parameters defined by the Service. Discrepancies

[1] *The delivery of free software for the preparation of returns and the direct input through Internet allows to reduce mistakes of this nature.*

may refer to differences in the taxable base, credits objected, refund amounts, payment amounts, etc.

The number of default levels is different according to the massive examination process that is being performed, but normally there are 8 levels.

Each examination of observations is independent among each other therefore, a return could have more than one inconsistency and each with different default levels.

Taxpayers to be examined are selected pursuant to the a policy that considers the nature of the defaults, the amounts involved, the attention capacity of the taxpayers, among others, dividing the matrix in two groups: one with levels of noncompliance higher then the level selected, which are the objected taxpayers, and another group with secondary observations that shall not be examined in-depth.

2.5 Deliveries to Treasury

After the batch process, all returns, even those that shall be submitted to examination are informed to the Treasury Service for the loading process into their systems.

2.6 Notification Process

Taxpayers selected from the default matrix, will be informed of their situation through different means, in what constitutes the production process of taxpayers' notifications; these notifications may be done through a letter, fax or e-mail.

2.7 Attention Through Internet and Attention at the Operative Units

Taxpayers have the option to correct their inconsistencies through Internet, where they additionally have access to notification letters, to the observations whereby they have been notified and orientation is provided to solve their problems. In the case of VAT Operation the notified taxpayer may directly correct his inconsistencies and on-line with the historical database, which translated into a substantial improvement in the quality of the service, processing time reduction and less administrative costs.

The objected taxpayer may also present himself to the Operative Units to clarify the inconsistencies detected in his return, where the officers have support computer systems that facilitate attention.

2.8 Results of the Attention Process

Correction of Returns
Notified taxpayers correct inconsistencies through Internet or appear before the Units. If the return's inconsistencies were correctly generated the taxpayer must correct his return to correct the differences.

Released Returns
Self-attention through Internet or the taxpayer's attention at the Operative Units also generates the release of the return. When the taxpayer complements with additional background that clarify his tax situation the Internal Revenue Service proceeds to free the same.

Audited Taxpayers
If in the review of the observed return, inconsistencies are detected and the taxpayer does not accept to correct or the situation deserves a more in-depth review, it is then determined that the taxpayer must be summoned to practice an audit pursuant to the standards in force.

2.9 Tax Assessments Issue Process

Assessments are generated during different stages of the massive process. The first issue is done in the batch processes and corresponds to difference assessments for payments outside the term, which are generated at the same time as notices to objected taxpayers. A second issue, after the former, takes place when on-line assessments are issued when the corrections are made in returns notified by the batch process, these are called assessments due to tax corrections. The third issuance of assessment is produced in other batch processes, where assessments are issued to taxpayers that do not appear for the notification and these are called tax assessments due to non-appearance.

These assessments issued and generated are sent to the Treasury Service for their processing and charge in the Sole Taxpayer Account (checking account of the movements of each taxpayer).

Hereinafter we shall describe massive examination processes: Income Operation, VAT Operation and Vector Operation.

3. INCOME OPERATION

3.1 General Description of the Process.

One of the main examples of the massive examination process is that Income Tax in the Chilean case is filed every year in April, where taxpayers declare the totality of their annual income and pay the corresponding taxes and/or request a refund on account of monthly inputted credits. The examination and control process of Annual Income Taxes is known as Income Operation, and, consists in a computerized examination where returns are examined in a tax, logic and mathematical manner with data from the return itself and with information external to the document. The purpose of the Income Operation is to perform an integral review of Annual Income Tax Returns by carrying out collections if this is the case and by implementing a clear and precise communication system with taxpayers.

Every year during the months of February and March, Sworn Returns are received from Informing Agents at the Tax Administration, where these deliver detailed information on withholdings coming from work income, interests perceived, real estate acquisitions, shares in corporations, dividends, donations, among others. This information is known as External Income Vector and is used to verify what has been filed by taxpayers in the Income Tax Return. Approximately 800,000 returns are received, of which 57% were delivered through the Internet in the year 2000, corresponding to 95% of the total information volume coming from Informing Agents.

The following activities stand-out in the global Income Operation control process:

a) **Determination of Mathematical Inconsistencies.** When taxpayers fill their returns they make mistakes, for example: wrongly performed additions, subtractions and multiplications, the incorrect use of certain fields, which is translated into mistakes inherent to the return. These returns are known as Imbalanced.

b) Determination of Tax Inconsistencies. Taxpayers that register in their returns different from that informed by external agents, said differences are questioned and notified.

c) Double Filer Control. Taxpayers that file more than one return for the same tax period are called Double Filers, these are observed since they must only file one form.

d) Payments and/or Tax Differences. Differences resulting from arithmetic mistakes and imply differences in the final result of the return, such as greater or lesser payment or greater or lesser request of tax remainders.

e) Selection of Returns to be Examined. From the universe of returns with some level of inconsistencies determination is made of those that shall be objected, by selecting those that maximize collection, this criterion must be applied given the restriction of available resources.

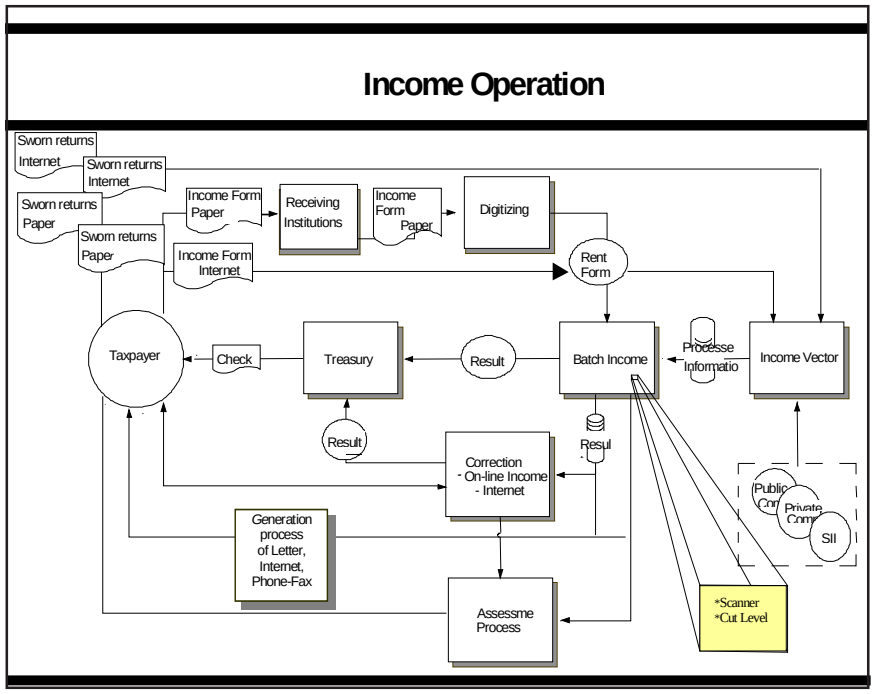
In the selection process two sub-processes are distinguished:

- Selection by Scanner.
  Consists in selecting returns in function of the seriousness levels of each.

- Selection by Benefit of Taxpayers with Good Behavior. Applied to determinate returns in the foregoing step, considering the amount of the discrepancy and its objective is the benefit taxpayers with good behavior that request a refund, freeing the requested remainders, even though the return is objected.

f) Authorizations for the issue of refund checks. The Treasury Service performs the massive issue of checks, in two stages. The first is applied for taxpayers that file their income tax return in paper up to the first fifteen days of the month of April or until May 2, when done through the Internet; the second stage is for the rest.

The following figure describes Income Operation in general terms, with its main events:



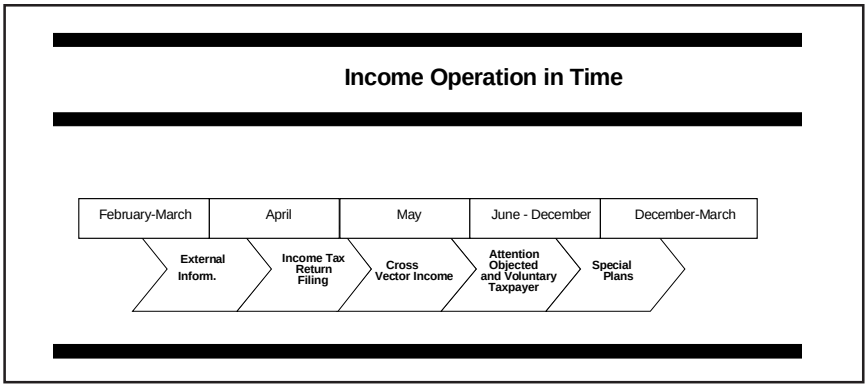


Fig. 2 General Scheme of the Income Operation Process

3.2 Specific Objectives of the Process.

The objectives defined for the process are the following:

- To control and detect tax, mathematical and identification mistakes.
- To control taxpayers that file more than one return.
- To control of non-filing taxpayers.
- To have a dynamic crosschecking of external or internal sources of information system, that is, to have an update procedure as new data arrives.
- To timely update information systems.
- To issue notifications by packages, that is, groups of letters with certain characteristics in previously defined time intervals are printed and sent.
- To issue assessments, generated in computer checks, ending the taxpayer attention process.
- To generate corrections, issuance of assessments and payments of the later in a massive manner through the Internet.
- To improve the quality of the Service by incorporating information technologies, the Internet, in the Chilean case.

3.3 Income Vector Process

The information to be used during all processes that comprise the Income Operation comes from two sources: income tax returns, that is known as internal information and, information coming from other sources, such as private or State institutions, Sworn Income Tax Returns required by the Service and Information coming from VAT Returns. The definition, validation, management and transformation process of all internal and external information is called Income Vector.

The means in which the information is presented from the different external entities is mostly through the Internet and in lesser scale through Paper, Tapes or CDs. To generate returns the application placed at the disposition by the SII (through Electronic Forms and Free Basic Software) or Certified Software from companies authorized by the Service. Figures for the year 2000 of returns from external agents are presented hereinafter:

Presentation Means Sworn Income Tax Returns from External Agents	N° of Returns	%
- Paper	349,451	43.9
- Electronic Internet List	114,317	14.4
- Free Internet Software	200,225	25.2
- Internet Software Businesses	130,873	16.4
- Tape or CD	287	0.04
Total	**795,153**	**100.00**

Information received through the different means, after it is processed and submitted to different external and internal validations, is loaded into the SII databases.

In regards to Income Tax Returns, in the year 2000 a total of 467,053 returns were filed through the Internet, this pertains to approximately 25.5% of the total:

Presentation Means of Annual Income Tax Returns	N° of Returns	%
- Paper	1,365,331	74.5
- Electronic Internet List	166,517	9.1
- Free Internet Software	155,644	8.5
- Internet Software Businesses	144,892	7.9
Total	**1,832,384**	**100.00**

The construction of the Income Vector is a dynamic process, that is, whenever new relevant information is received a new transformation process of the information is performed and the existing Elements of Income Vector are updated, generating a new file for the following control processes.

The dynamics of the Income Vector is the main generating source of updates for all processes that comprise Income Operation, that is, if the Vector is changed, all information resulting from the re-examination of the returns must be updated.

The construction date of the Income Vector is generated and stored, Vector Date, which is available whenever information is extracted from the same, such as for example in the Batch Process, On-Line Internet Query, On-Line Corrections and Internet Correction.

3.4 Income Batch Process

The systematic review of computerized examinations, to which Annual Income Tax Returns is known as Income Batch. This process requires different inputs to achieve its execution; the main are Elements of the Income Vector and the information from returns.

The returns observed are all those that some level of mistake is detected product of the data cross checks with the different sources of information, and those not observed are returns that do not present any discrepancies. The seriousness, depending of the differences detected, is classified in eight levels.

Income Operation verifies the consistency of the returns filed by taxpayers and also considers those that do not comply with their obligation to file a return, through 93 observations, among which we have 6 on identification, 14 quadratures, 12 arithmetical and 61 tax observations.

An example of the type of observations for the Income Operation is A-58 (see Annex No. 1), which compares payments on the account of the personal taxes filed by the taxpayer (withholdings from professionals), with what has been informed by the withholding agents of said payments to the Internal Revenue Service.

3.5 Taxpayer Selection

On Table 1 part of the tax default matrix from the Income Operation 2000 appears, in the row that indicates the amount of returns that present a determinate observation, distributed in the 8 levels of default or seriousness. For the selection of taxpayers to be examined the nature of the observation is considered as well as the amounts involved, the importance of the observation and attention capacity at the Operative Units.

TABLE 1: Scanner Income Operation 2000, Returns considered with Refunds

Observation Type	Return Default Levels										
	Level 1	Level 2	Level 3	Level 4	Level 5	Level 6	Level 7	Level 8 Observed	Total Leve	Cutl Objected Taxpayers	Total
A01	3118	3486	965	521	362	268	199*	1447	10366	7	1646
A02	95	134*	85	57	45	46	38	460	960	2	865
A04	4	4*	2	2	4	2	3	2	23	2	19
A05	1207	4439	244*	93	54	31	17	46	6131	3	485
A07	883	377	175*	125	81	37	28	210	1916	3	656
A12	0	0	0	0	0	0*	0	56	56	6	56
A50	619	391*	183	86	67	43	33	408	1830	2	1211
A53	620	396*	236	175	117	127	125	1020	2816	2	2196
A58	39,607	15,264	6,630	3,724 *	2,239	1,757	1,188	5,498	75,907	4	14,406
A87	261	77*	53	26	21	17	12	125	592	2	331
A88	2,026	1,013 *	402	195	82	50	43	180	3991	2	1965
A89	364	78*	58	31	29	23	23	325	931	2	567
A91	587	904	557	401	218	171	92	614	3544	9	0
A59	1462	611	303	217*	124	83	51	510	3361	4	985
D02	164	83	42*	35	10	17	9	129	489	3	242
F16	830	233*	101	57	45	22	21	204	9481	2	7584
F91	16472	3649	873*	423	283	195	135	1236	23266	3	3145
F93	27426	6553	1011	439	273	161*	152	1479	37494	6	1792
G41	4560	1765*	522	255	174	111	80	412	7879	2	3319
G45	493	173*	97	64	50	32	32	88	1029	2	536
G47	22	3987	1471	768	458	295*	193	1363	8557	6	1851
G51	1529	307*	151	59	50	48	34	165	2343	2	814
G53	10926	680*	280	179	130	66	46	407	12714	2	1788
G54	1420	636*	275	102	78	77	22	119	2729	2	1309
G60	1167	180*	106	43	37	23	23	159	1738	2	571
G77	3639	1059*	420	277	118	80	51	416	6060	2	2421

If we consider the case of observation A-58, which discrepancy levels increased in a fixed amount of $75,000 starting from zero, we observe that 15,264 returns remained in level 2, which differences are above $75,000 but lower than $150,000, that this, where the taxpayer presents an excessive amount of on account payments, when compared to what was reported by withholding agents between these values; in level 3 those returns present differences between $150,000 and $225,000 and so on. In the case of observation A-88 the increase in the fixed amount for each default level is 50,000.

Observations A-58 and A-88 grouped 75,907 and 3991 taxpayers observed, respectively, as from which the levels of seriousness are defined to select those that will finally be examined.

In the 2000 process, it was determined that as from the 4 levels for the observation A-58 and level 2 for A-88 the mark (*) is defined, as from which the same will be objected. For observation A-58, the taxpayers that were finally objected are 14,406 and for A-88 there were 1,965 objections.

Batch Process Results

From a total of 1,832,384 Income Tax Returns filed, 30.2% were returns with payment or payments equal to zero:

Type	N° of Returns	%
- Payment (P)	157,726	8.6
- Payment equal to zero (C)	395,567	21.6
- Total P/C	553,293	30.2
- Refunds	1,279,091	69.8
TOTAL	**1,832,384**	**100.0**

According to the chart above, 70% of taxpayers requested refunds, some of which were objected, but finally they are issued in a massive manner or approximately 1.1 million checks are deposited in the checking account.

Of the total returns files 16.2% taxpayers were objected, which were notified to present more background or correct their returns. In the following chart we can see the results of the batch process for the 2000 tax year.

Objected	N° of Returns	%
- Not Objected	1,534,837	83.8
- Objected	297,547	16.2
TOTAL	**1,832,384**	**100.0**

3.6 Issuing Letters in the Income Operation Process.

The result of the Batch Process is formally informed to taxpayers regarding any problem (Objected and Minor Differences) through Letters, where they are informed on which are the differences detected by the SII, the information they must submit and when and where should they go.

The means used are:

- Electronic means that SII has, that is, Internet, telephone and fax, in addition to e-mail notices that began early this year.
- Through mail, delivering to taxpayers Notice Letters, where their situation is described and the means to solve it.

Different types of letters with different functionalities are defined, where the most important ones are the Notice Letter, Notification Letter and Letter for Non- Appearance.

a) The Notice Letter is the document that is immediately loaded in the Internet and in the same inconsistencies detected are detailed. Furthermore, this letter may be obtained through the telephone and fax.

b) The Notification Letter has characteristics similar to the above, with the difference that it is sent through the mail system to the filers address and it has assigned the place and attention date at the Service's physical units.

c) The Non-Appearance Letter is a re-notice that informs the taxpayer the he/she did not appear on the date indicated in the Notification Letter.

3.7 Process for the Issuance of Assessments

Product of the integral review that must be applied to the returns, the **Issue of Assessments** must be periodically executed; the same is performed through on-line or batch processes, as it may pertain.

On-line assessments are differences in favor of the Treasury generated by corrections in the Service Units in the attention process or through self-attention through the Internet. Batch assessments are documents issued centrally, without the taxpayer's presence, product of him/her not appearing to respond to the notification.

3.8 On-Line Income Operation Process

After issuing a Notification Letter, the On-line Income process begins; this stage comprises attention for cases Objected during the Income Batch. In this process voluntary taxpayers that personally appear in the Service are also attended (Non Observed and Secondary Observed).

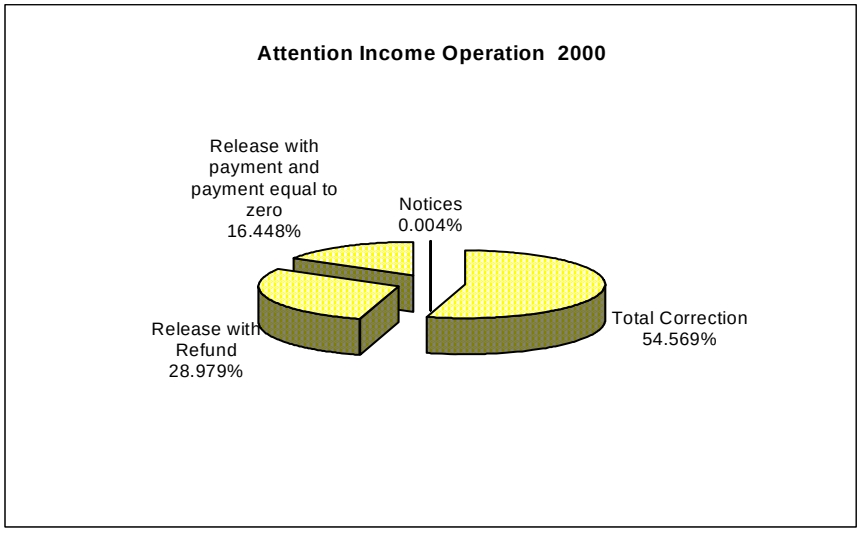
This process uses the on-line system that supports the tasks of the officials, where different actions may be carried out, for example:

- Return queries and tax situation.
- Correction of questioned returns.
- Assessment issuances to collect the differences product of corrections.
- Input of manual Notices performed by the Units: In addition to these generated in the massive Notification process.

A) Results of the On-Line.

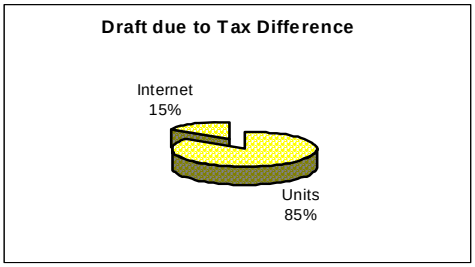
	YEAR 2000 (M$)					
	Units		Internet		Total	
	N° of Cases	Entry into the Treasury in Favor	N° Cases	Entry into the Treasurv	N° Cases	Entry into the Treasurv
Correction						
Primary Return with Refunds	78,521	17,123.9	13,730	652.4	9,251	17,776.2
Primary Return with Payment	15,804	3,497.3	2,545	1,301.6	18,349	4,798.9
Primary Return with payment equal to zero	9,669	22.2	1,751	-108.8	11,420	-86.7
Total Corrections	103,994	20,643.4	18,026	1,845.1	122,020	22,488.5
Release Units					25,271	
Electronic Units					39,528	
Appearance to Units					11,821	
Electronic Appearance					24,957	
Notifications					9	
Total Examined	**103,994**	**20,643.4**	**18,026**	**1,845.1**	**223,606**	**22,488.5**

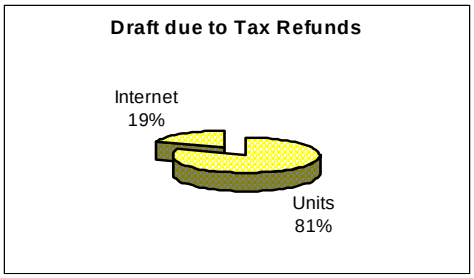
Statistic: January 31st, 2001
US$ January 2001, exchange rate: dollar average observed: $571.10/ US$.



Of returns objected 14.7% were corrected through Internet.

B) On-line Assessment Statistics





C) Non Filer Plan in the Income Operation Process 2000

As from January 2, 2001, attention began in the Units for individuals notified by the Non Filers of Annual Income Tax Return Plan for the year 2000. The number of persons attended at the Units and Non-appearing Taxpayers to this plan appears in the following chart:

Regional Directorate	Total Notified Special Plan	Total Notified date	Total Served at the Units	%	Total Served by Internet	%	Total Attended Plan Non Filers F22	%	Total Non Appearance	%
1	317	317	65	20.50	9	2.84	74	23.34	243	76.66
2	599	383	123	32.11	16	4.18	139	36.29	244	63.71
3	129	129	31	24.03	2	1.55	33	25.58	96	74.42
4	188	188	52	27.66	16	8.51	68	36.17	120	63.83
5	1,645	1,645	513	31.19	137	8.33	650	39.51	995	60.49
6	502	502	183	36.45	35	6.97	218	43.43	284	56.57
7	201	201	36	17.91	13	6.47	49	24.38	152	75.62
8	1,180	1,076	387	35.97	55	5.11	442	41.08	634	58.92
9	178	178	33	18.54	12	6.74	45	25.28	133	74.72
10	268	268	64	23.88	20	7.46	84	31.34	184	68.66
11	38	38	7	18.42	1	2.63	8	21.05	30	78.95
12	259	256	32	12.50	17	6.64	49	19.14	207	80.86
13	803	803	142	17.68	62	7.72	204	25.40	599	74.60
14	1,207	1,066	317	29.74	158	14.82	475	44.56	591	55.44
15	4,519	3,861	942	24.40	452	11.71	1,394	36.10	2,467	63.90
16	1,199	1,199	320	26.69	103	8.59	423	35.28	776	64.72
Total	**13,232**	**12,110**	**3,247**	**26.81**	**1,108**	**9.15**	**4,355**	**35.96**	**7,755**	**64.04**

Statistics: February 14, 2001.

The performance of the Non Filers Plan at February 14, 2001, appears in the following chart:

				APPEARIN	%	IN PROCEEDINGS	%	ATTEND	%	TOTAL
INTERNET	N° of Cases			1,108	25.35	0	0.00	0	0.00	**1,108**
	US$	Tax	+	660,730.8	25.74	0	0.00	0	0.00	**660,730.8**
		Taxes and Fines	+	219,759.0	24.16	0		0		**219,759.0**
		Total to Pay	=	880,489.8	25.32	0	0.00	0	0.00	**880,489.8**
UNIT	N° Cases			2,793	63.90	316	7.23	154	3.52	
	US$	Taxes	+	1,901,960.7	74.21	0	0.00	0	0.00	**1,901,960.7**
		Taxes and Fines	+	688,873.3	75.81	0	0.00	0	0.00	**688,873.3**
		Total to Pay	=	2,590,833.9	74.63	0	0.00	0	0.00	**2,590,833.9**
INTERNET/ UNITS	N° Cases			3,901	89.25	316	7.2	154	3.52	**4,371**
	US$	Taxes	+	2,562,691.5	100.00	0	0.00	0	0.00	**2,562,691.5**
		Taxes and Fines	+	908,632.3	100.00					**908,632.3**
		Total to Pay	=	3,471,323.7	100.00	0	0.0	0	0.00	**3,471,323.7**

Statistics: February 14, 2001. Percentages refer to the TOTAL
US$ at January 2001, exchange rate observed: $571,1/ US$

3.9 Computer Application for the Attention of Taxpayers: Rentanet

In Internet, through what has been called RentaNet, taxpayers can file their Annual Income Tax Return and Sworn Returns, in the initial filing as well as in the possible corrections to these returns.

To file the Income Tax Return there are three alternatives to prepare the return:

- Through the use of a basic Software, that is distributed free of charges through the Service's Web page.
- By directly filling out the on-screen electronic return form.
- Through commercial type software, certified by the Internal Revenue Service.

In all alternatives logical-mathematical validations are made, to mainly avoid quadrature mistakes.

As from the year 2000 taxpayers may additionally carry out their corrections, obtain assessments and obtain external information (Withholding Agents) for the preparation of the return.

4. VAT OPERATION AND VECTOR OPERATION

4.1 General Vat and Vector Operation Description

Other massive examination processes carried out by the Chilean Tax Administration, these are VAT Operation that began on October '98 and Vector Operation that began on December 2000.

VAT Operation is a permanent, structure and massive examination plan for the Value Added Tax. It is executed on each return period by reviewing the total returns filed, pursuant to structured rules, in a computer process, which result is the selection of objected returns, which shall be examined with greater depth.

Vector Operation is a structured and massive examination plan of Sworn Return. Whenever it is executed, total returns filed up to that moment is reviewed, pursuant to the different types of validations performed through a computer process, which result is to obtain objected returns, those that shall be examined. All process that the External Vector are dynamic, that is, the process is performed whenever a reconstruction of the elements is deemed necessary due to the arrival of new information.

4.2 Specific Objectives of Iva and Vector Operation.

Among the specific objectives of both processes we have:

- To control the obligation to file a return (non-filers).
- To control and detect tax mistakes, logical - mathematical mistakes and quadrature mistakes.
- To control taxpayers that file more than one return, multi-filers.
- To detect debit sub-filing taxpayers and/or that wrongly use some credits allowed by the legislation.
- To build a dynamic VAT Vector, that is, to have a computer tool that allows updating in the measure in that new data arrives and query the same.
- To offer good quality service through Internet, delivering greater information regarding notification statements, observations generated, filing and correcting on-line.
- To carry out Special Plans with non-appearing taxpayers to the IVA Operation process.

4.3 Generation of Observed Returns and Cross Checks With External Information

The process begins with the input of a return's database, to which a validation computer process is performed, by verifying the arithmetical logics with quadrature and validation rules, which correspond to the observations. A file is extracted from the process with all the returns observed.

After the generation of the observed returns file, tax consistency is reviewed through the comparison with previous returns and/or through cross checks with external information sources. Each inconsistency or observation has a discriminant, which accounts the amount questioned for this observation. With this observation a 'scanner' matrix is generated, the same shows the number of observed taxpayers by seriousness level, which jointly with the attention capacity in the operational units and the importance of the observation shall define the cut level to be performed.

Jointly with these examination, taxpayers that do not comply with the obligation to file are controlled.

Information is monthly received from external agents, such as information from refunds due to Exports and Fixed Assets, VAT Tax Withholding Agent Returns (Tax Subject Change), Left out Cashiers (rejected) of returns delivered by Banks, Taxpayer's Lists that have tax franchises and who are allowed to file in a manner different from the normal regime. This information constitutes the VAT Operation Vector.

In the External Vector Operation, all information that does not come from the Income Tax Form from the year or from the Monthly Return form, is delivered by taxpayers, natural persons or bodies corporate, such as companies, banks, brokerage agents; State institutions such as the Civil Registry, INP, Ministry of Education. This information constitutes the vector of sworn returns.

The generation of the Elements of the Vector must be done periodically as the information arrives to SII's database.

There are four kinds of Information Sources: Sworn Return Forms, the Service's Lists, the Service's Databases and External Lists.

- ***Sworn Return Forms***
  Correspond to the mandatory sworn returns that certain taxpayers must file every year, as provided for by the Internal Revenue Service. Returns may be filed through different means that the Service puts at the taxpayer's disposition, these are: Paper, Magnetic Tapes, CDs or Internet.

- ***Service Lists, Service Data and External Lists***
  Taxpayer's lists that show any problem that must be considered in the process, as well as taxpayers that have special benefits due to franchise tax.

4.4 Vat and Vector Operation Notification Process.

The objected taxpayer file is process with the cut levels for each observation obtaining the notified persons file. A taxpayer shall be notified when at least one of the observations that he/she files is above the cut level defined for him/her. Notifications may be done through a notice letter, e-mail or Internet.

4.5 Vat and Vector Operation Attention Process

The attention process begins with the issuance of letters t notified taxpayers, which may come to the Service Unit corresponding to their domicile or correct through the Internet..

In November and December of the year 2000, for VAT Operation, taxpayers through the Internet made a total of 54,106 corrections, thus representing 28%. 70% of the returns corrected were done on-line by the examiners and 1.5% were received on paper, the same were digitized later.

4.6 Computer Application Available for Taxpayers: Ivanet

This is an application that allows to perform all actions related to the Monthly Simultaneous Return and Payment form F29, there is a version for the taxpayer through the Internet at the Website of the Tax Administration and another version to be used by the examining auditor through the institution's Intranet, which has more

ample access. In general both systems allow to perform returns and corrections to the same, to consult the taxpayer's tax situation status and obtain copies of payment documents and notices.

To file the Monthly Simultaneous Return and Payment form 29 through the Internet there are two alternatives:

- Through the use of basic Software, that is distributed free of charge on the Service's Web page.

- By directly filling the on-screen return form.

In all alternatives logical-mathematical validations are performed to avoid quadrature mistakes.

Information from the different agents may be filed through Paper, Tapes, Cds or through the Internet, the alter by using the application made available through the SII (Electronic Forms and Free Basic Software) or the Software Certified by the Service.

4.7 Vat Operation Assessment Issuance

The draft is characterized for being compensatory of differences detected in the IVA Operations Plan. Two types of quadratures errors are distinguished, for the one part the same pertain to partly to discrepancies between partial operations regarding the total within the form (taxes) and on the other to differences of legal surcharges (interests and fines). Partial differences in taxes are notified, and differences due to legal surcharges generate immediate assessment.

Once the taxpayer appears before the Unit, due to a notification, the return is corrected and an assessment is generation through on-line application. Later, if the taxpayer does not appear and respond to the notification the respective assessment is issued in a batch process.

5. INNOVATIONS TO MASSIVE PROCESSES

a) Income Operation 2001 Draft Proposal.

For the 2001 tax year, Annual Income Tax Returns shall be proposed to approximately 1,444,000 taxpayers, this is equal to 72% of the total Natural persons.

Access to this application in Internet will be found in the Income menu of the Service's Web page, delivering prior to the Draft the summary of the Information from Withholding or Informing Agents, with the objective that the taxpayer is aware of the detail of the information with which the proposal was built. Additionally, the taxpayer shall have the possibility of inputting information through the Withholding Agents Information Collection option, the same is explained in the following item.

b) Withholding Agents Information Collection informed by the Taxpayer.

Prior to filing their annual income tax returns, the taxpayer will have the option to deliver tax information whether it coincides or not or information that has not been previously delivered through Sworn Returns. This additional information is directly inputted through the Internet and shall be incorporated to the available information that is already registered for said taxpayer.

c) On-line Returns and Corrections.

As from February of this year the taxpayer may file his VAT return and/or correct through the Internet, with direct access and on-line as from the 1994 tax period, this optimizes attention and processing times, lowers information management costs and allows to deliver better quality service.

6. DEFICIENCIES AND PROBLEMS ASSOCIATED TO MASSIVE PROCESSES

Strong advances have been made in massive processes in the structuring of the processes, incorporation of new information cross checks and in taxpayer attention.

This advance has also meant difficulties, mainly in the following aspects:

a) Information quality and timeliness: process frequencies and the interrelation of the different stages requires to make sure that the information is always available and that it does not have mistakes. Notwithstanding the above, currently, part of the historical information registered in the systems presents mistakes, this affects current processes.

b) Difficulties in technical support for internal and external users: this is product of the increase in the amount of applications, Internet and Intranet empowerment and in addition to the multiplicity of geographically distributed users.

On the other hand, advance is required in order for the results of the process to have greater direct and indirect impact in the collection. Currently, the VAT Operation process, that generates a large amount of notifications, does not present the results expected due to the high rate of non-appearance to the notices made.

Additionally, greater development of indicators is required, which on the one hand, allow to classify taxpayers in strict compliance and on the other allow to measure the effectiveness of the examination process as such, with the purpose of feeding back to the taxpayer selection stage.

The combined effort of a taxpayer good selection with the stages that take place after the massive process, must be directed towards reducing tax evasion and motivate complying taxpayers.

7. CONCLUSIONS

The massive processes described in the document herein, are mainly directed towards controlling Income Tax Returns and VAT, these have a great social impact and indirect effects, due the incidence that this has in the taxpayers as well as due to the amount of objected taxpayers that it generates.

In this regard, certainty in said processes is important, therefore Tax Administration must have good information systems, untainted and reliable, good quality and timely databases, which allow to

identify and clearly determine taxpayers in terms of basic data, as well as in regards to other guidelines and indicators to achieve adequate classification and later examination.

Information technologies must be capable of supporting information at all process levels, as from the moment returns are received, the objection generation process, notices and user attention at the Operational Units and mainly through Internet.

In the Chilean case special emphasis has been place on improving service quality through the globalization of INTERNET, as strategic communication and transference of information means with the taxpayer.

Therefore, in the Income Operation case the proposal of a return to the taxpayer based on information that the Internal Revenue Service has represents a quantum leap in the process of improving service quality, attention times, and the optimization of resources. This means to improve the quality of the control of massive process, data control and reduce information management costs.

Likewise, in the VAT Operation process, it is important to point out the fact that the taxpayer when he files, corrects or makes inquiries to his information through the Internet or in the Institutional Intranet, the information is displayed on-line and any modification made thereon is updated in real time.

In the same manner, the External Agents Cross Checking Information process, the largest amount of information is received through the Internet. This has enormously favored information management cost reductions, thus improving the quality thereof and this has been translated into a significant increase in the quality of service to taxpayers and in the assertion of the examination.

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ANNEXES

Annex Nº1

Observation A-58 may be described as follows, algorithm that is alter programmed in a computer language to then perform cross checks:

A58: INCOME CONTROL AND/OR SECOND CATEGORY WITHHOLDINGS ART. 42 N° 2.

Income tax form line : 6 and 47
Income tax form codes : 110, 198 and 611

OBJECTIVE:

To control the Income Tax of Articles 42 N°2 and 48 of the Income Tax Law declared on Line 6 of the income tax form; and tax withholdings practiced thereon, pursuant to the provisions of numbers 2 and 3, of Article 74 of this same legal text, declared on Line 47 (code 198 of the Income Tax Form).

CONCEPT:

Withholdings declared in code 198 (through code [611]) of the income tax form, must correspond to the sum of what has been informed by the withholding agents in Forms 1879 of Sworn Returns and corporate directors' fees and remunerations declared in code 110 must be consistent with said withholdings.

$$[\lambda] = \begin{cases} MAX\{[465];[\mu]\} & ;si\,[465]*[494]=0 \\ MIN\{[465];[\mu]\} & ;si\,[465]*[494]\neq 0 \end{cases}$$

$$[\beta] = POS\{\ \frac{Vx11+Vx07+Vx148}{P24}+\frac{Vx149}{P22}\ +[617]-[\lambda]-[\omega]-50\ \}$$

$$[\phi] = Vx07+Vx148+Vx149 - POS\{[611]-[54]\}$$

$$[\rho] = [\beta]-[110]$$

$$[\eta] = TGL\ \{\ POS\ \{\ [R170]-POS\{-[\rho]\}\ \}\ \}$$

$$[\theta] = POS\ \{\ [\eta]+[201]-[CGLO]+[162]-MAX\{[162];Vx48;TGL\{Vx53\}\}\ \}$$

$$[\tau] = TGL\{[R170]+POS\{\ [\rho]\ \}\ \}$$

$$[\alpha] = POS\{\ [\tau]+[201]-[CGLO]+[162]-MAX\{[162];Vx48;\ TGL\{Vx53\}\}\ \}$$

$$[\zeta] = MIN\{\ [31]\ ;\ [R31]\ \}$$

$$[\chi] = POS\{\ POS\{-[\phi]\}-POS\{[\zeta]-[\theta]\}\ \}$$

$$[\pi] = [\kappa]*POS\{\ POS\{\ [\alpha]-[\zeta]\ \}-POS\{[\phi]\}\ \}$$

Observation Standard:

$[\chi] + [\pi] > P31$

DIF = $[\chi] + [\pi]$ ***(Tax Difference)***

DISC = DIF ***(Discriminant)***

RETE = DISC ***(Withholding of Requested Refund)***

SCANNER:

- 75.000 en 75.000.-

LETTER TEXT:

"Corporate Director's Fees and/or Remunerations declared on Line 6 and/or withholdings on Line 47, Code 198, are inconsistent with what has been informed by the respective Withholding Agents or with what has been directly stated by you in monthly returns."

Case study:

TOPIC 2.1

THE PROCESSING OF TAX RETURNS FOR DETECTING ERRORS, INCONSISTENCIES AND OMISSIONS

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CONTENTS: Introduction.- I. Evolution in the Control of Tax Obligations.- 1. Background.- 2. Characteristics of fiscal control following the modernization.- II. Current Situation.- 1. The Venezuelan tax information system – SIVIT.- 2. Special taxpayer units as collection and control strategy.- 3. The Need of a new approach to examination.- 4. Examination of the pilot test.

INTRODUCTION

Of vital importance, is the permanent adaptation of tax institutions in accordance with the modifications to their socioeconomic and cultural contexts, through the incorporation of innovative elements in their organization, as part of a natural evolutionary process.

In fact, the 35th General Assembly of the Inter-American Center of Tax Administrations - CIAT is an excellent occasion for the exchange of knowledge and experiences in relation to "The Tax Administration's Examination Function and the Control of Evasion" since, currently, the globalizing process of the economy and modification of the markets require significant changes in this fundamental role of our tax administrations.

In the particular case of Venezuela, the latter does not escape the common denominator which affects almost all countries and consists of limited response capacity in exercising fiscal control, conditioned by a scarce examination force vis-à-vis a population of taxpayers in constant mobility and growth. In this sense, the use of information and control systems has allowed for instrumenting methodologies for exercising massive controls on formal and substantial aspects of the returns filed by the taxpayers, which results, once the information has been processed, in parameters that guide the examination action.

The presentation and development of the topic: “The Processing of Tax Returns for Detecting Errors, Inconsistencies and Omissions”, on the part of the Venezuelan Tax Administration, ratifies the latter’s intention to contribute to guide those countries currently committed to similar processes and which comprise the dynamic CIAT community.

I. EVOLUTION IN THE CONTROL OF TAX OBLIGATIONS

1. Background

The tax reform in Venezuela, as part of the modernization process of its respective Tax Administration, has been one of the Venezuelan projects of greater impact. It began in 1991, with a view to diminishing dependence on oil revenues as a source of State financing and for facing the structural crisis of the public finance system, and was materialized in 1994 with the creation of the National Integrated Tax Administration Service – SENIAT, through Decree No. 310 of August 10, 1994. Its most relevant characteristics has been the integration of the Customs and Internal Revenue services in a single organization. Before its creation, the Venezuelan Tax Administration had a structure that was equally dependent on the Ministry of the Treasury, now the Ministry of Finance, formed by the General Sectorial Directorate of Income, under whose subordination was the Fiscal Control Directorate which is responsible for establishing the procedural standards intended for such purpose and whose most outstanding characteristics were:

- In-depth audits of long duration, fundamentally with respect to Income Tax.
- Non-existence of specific programs or fiscal presence for the verification of compliance with formal duties.

- Unreliable database and technological limitations for controlling nonfiling or extemporaneous taxpayers, as well as for systematically detecting errors in the returns.

The modernization project undertaken by means of an agreement with the Inter-American Development Bank, allowed for the signing on January 10, 1992 of an agreement between the Ministry of the Treasury and the Inter-American Center of Tax Administrations for the execution of the project, one of whose characteristics was the implementation of a strategic plan which was aimed at the struggle against corruption, the integration of the customs and internal tax systems, the increase of collection within short term, the reduction of evasion, the development of human resources and the strengthening of the tax culture.

Achievement of the objectives posed, implied the follow up of strategies, the most important ones identified being: the reform of tax laws, development and training of the human resource, development of automated and integrated systems that would allow for generating reliable tax information, creation of Special Taxpayer units, development of special examination programs and simplification of payment procedures through the banking system.

2. Characteristics of Fiscal Control Following the Modernization

After the creation of SENIAT, the new examination policy began to substitute the in-depth audits with specific procedures also called of fiscal presence. This policy, as new examination concept, endeavors to control effectively and efficiently compliance with fundamental duties, while maximizing taxpayer voluntary compliance. This change in the examination policy is based on the fact that voluntary compliance depends on the perception which society has, in relation to the administration's capacity for detecting fraud and applying the fiscal rules to those who fail to comply voluntarily and reserving individual controls by means of in-depth investigation actions, to audits aimed at carefully pre-selected groups of taxpayers.

Some of the main strategies identified are:

- Census of taxpayers through a technique that separates them according to geographical zones.

- Development and application of specific examination programs, of short duration, fundamentally for Value Added Tax – VAT.

- Creation of a database for the application of other complementary programs.

The foregoing resulted in a considerable increase of administrative acts that impose sanctions, for which the rest of the organization is not prepared, as regards its transcription, assessment, notification and collection procedure and which paradoxically entails a decrease in the subjective risk perceived by the taxpayers, given the delay between detection of the violation and notification and collection thereof. This situation has called for developing systems for the capturing and processing of tax returns that may allow massive, selective and timely control of fundamental obligations and duties of the taxpayer population.

II. CURRENT SITUATION

1. The Venezuelan Tax Information System – SIVIT

This system arose in 1994 as a necessary platform for massively processing the information found in the tax returns received through the banking system by express delegation made by the Venezuelan Tax Administration to commercial banking.

In the first semester of 1993, the Ministry of the Treasury, now Ministry of Finance, signed a new agreement with the national banking network providing for the obligation of commercial banking, as regards the receipt of tax returns and collection of taxes, as well as transmitting the following working day, the information received daily, thus becoming the main means for the control of operations carried out by the population of filing taxpayers.

The SIVIT is designed and structured on the basis of three subsystems, which are directly administered by SENIAT, each of which pursues different specific objectives, that are in essence integrated to achieve a general vision in exercising control. Such subsystems are:

- Taxpayer File: its objective is the determination of the fundamental characteristics of the country's taxpayers, determining who they are, what activity they carry out and

where they are found, and additionally identifying the obligations to which they are subjected.

- Control of Banks: allows for controlling compliance of banks with the obligations provided in the agreement, as regards the timeliness of delivery of the return batches and magnetic files, where said documents are recorded, as well as the transfer of funds collected by the Central Bank of Venezuela – BCV.

- Assessment of taxes and taxpayer Current Account: Its purpose is the massive control of compliance with tax obligations by the taxpayers, specifically as regards timeliness in the filing of returns and payments, whose term is provided in each one of the Venezuelan special laws. This subsystem marked the beginning of automation of the controls exercised by the Venezuelan Tax Administration, which positively modified the latter's response capacity, on permitting the detection of errors and their automatic normalization in the returns filed by the taxpayer population, control of payments as mechanism for the cancellation of tax obligations, as well as detection of nonfiling taxpayers in real time and their systematic follow-up.

It is important to note that in order to give juridical validity to the administrative acts issued through computer systems in the collection and examination activities, article 113 was included in the Organic Tax Code of 1994 as part of the legal tax reform undertaken within the framework of the modernization project. This article additionally affords the possibility of substituting the autograph signature of the competent officials with a facsimile thereof or a wet seal, which constitutes a significant achievement as regards the capacity of response of the Venezuelan Tax Administration.

2. Special Taxpayer Units as Collection and Control Strategy

The creation of these units starting in the first semester of 1994, was based on the use of SIVIT as computer platform for controlling groups of taxpayers with similar characteristics, as regards their location and high collection potential, thus becoming the main strategy for the optimum application of resources available and

allowing the future gradual incorporation of the remaining taxpayer population and their relationship to the essential functions of the administration. These units allow for controlling small groups of taxpayers through seven of the ten Regional Management Offices comprising the operational level of SENIAT, by detecting in real time, the omissions, errors and delinquencies of 7,469 special taxpayers notified for the year 2000, which represents approximately 0.5% of the national taxpayer population that same year. This small sample of taxpayers currently contributes 47% of national collection by way of internal taxes.

The Special Taxpayer Units are strategically located in zones of greater commercial and industrial concentration, four of which are domiciled in the branches of the Industrial Bank of Venezuela throughout the national territory, and the remaining three, in the facilities of each of the operational management offices of the jurisdiction. The collection of payments made by special taxpayers was delegated to the Industrial Bank of Venezuela, through an agreement signed between the Ministry of the Treasury and that banking entity. The bank committed itself to provide physical space and computerized equipment, and the Ministry to the appointment and training of the human resource, as well as the provision of office supplies. The functional structure of said Units is divided into three coordination offices, namely:

- Bank Control Coordination Office: in charge of the receipt and immediate transcription of returns filed, through windows conditioned for such purpose, as well as conciliation of daily collections at the banking agency.

- Obligations Control Coordination Office: generates and issues at the end of the day on which the term for filing returns expires, the list and notifications of nonfiling taxpayers and their follow-up, with the application of the corresponding sanctions.

- Recovery Coordination Office: analyzes significant errors detected in the returns and, in addition, determines credits in favor of the Treasury, notifying them and undertaking administrative collection efforts.

Some of the inconveniences faced by these units are: lack of development of a marking subsystem for assigning status to credits in favor of the Treasury, which may allow for the precise detection and follow-up of delinquent taxpayers; lack of an application for

the consolidation of current accounts due to merger of companies; as well as lack of a list that may identify through time series, the number of taxpayers that file returns with errors.

CONTRIBUTION FROM SPECIAL TAXPAYERS

Description	YEAR 1995	YEAR 1996	YEAR 1997	YEAR 1998	YEAR 1999	YEAR 2000
Special Taxpayer Units in operation	5	8	8	8	9	9
Notified Special Taxpayers	3,096	4,134	6,556	6,508	6,936	7,469
Nonfilers Generated	492	16,818	24,274	35,405	48,166	42,458
Fines Applied (Millions of Bs.)	0,17	32.05	120.48	996.00	523.74	976.69
Special Taxpayer Collection (Millions of Bs.) (*)	139,688.06	507,387.93	1,350,981.21	1,934,503.77	2,406,913.62	2,684,887.54
National Collection of Internal Taxes	1,032,519.00	2,154,275.00	3,731,828.00	4,424,116.00	5,551,275.00	5,702,113.00
% of Collection from Special Taxpayers in relation to National Collection	13.53 %	23.55 %	36.20 %	43.73 %	43.36 %	47.09 %

Source: Special Taxpayer Management and Divisions, GEET of SENIAT, SIVIT System(*) For the year 1995 there is only information available from the Special Taxpayers Management Office starting on 05/15/95, date of establishment

3. The Need of a New Approach to Examination

Starting in January 2000, there has been a change in the examination policy at the National Integrated Customs and Tax Administration Service-SENIAT. A series of procedures have been implemented at the national level, with a view to the systematic control of compliance with tax obligations, in general, by ordinary and special taxpayers, which was methodologically called **Previous Selection for Examination.** This substitutes the traditional inductive examination model, with a deductive, selective and non-discretional model. The fundamental objective of this methodology is the increase of national collection through effective reduction of tax evasion. It consists of massively processing and analyzing the form and substance through “Tax Statistics Models” contained at SIVIT, of returns filed by the taxpayer population for the three most important taxes which are: Income Tax, Tax on Business Assets and Value Added Tax, to thus establish their veracity, by taking into consideration: the type of taxpayer (Individual or Corporate), economic activity (CIIU), location (Region) and economic period. This method, likewise supported by the Management Control System -CONGES, which follows up files from their establishment up to their conclusion or closing, allows for the massive verification of formal

aspects of the returns and, additionally, the selection of taxpayers that must be investigated in greater depth. All of this responds to the need to counteract one of the weaknesses in fiscal control that persisted after the tax reform of 1994. The aforementioned weakness consisted in the lack of definition of clear and objective parameters for guiding such important function, which resulted in excessive discretionality of the operational units in the selection of cases to be examined, with such consequences as: lack of technical support in decision making, examinations undertaken with low or little fiscal interest and subsequent decrease in the productivity of the examination system. It is expected that this new approach may result in the reduction of tax evasion, through:

- Unification of objective criteria for the selection of taxpayers to be audited at the national level, with a view to channeling resources to sectors or areas of greater collection potential, by eliminating discretionality.

- Scheduled summons for those taxpayers chosen to be examined, in order to promote voluntary adjustment, as well as: validate and modify on-line the elements of the Tax Information Register-RIF, verify the existence of omissions, verify formal aspects of the returns, analyze their financial statements and automatically assess the tax differences, fines and interest, all as a previous step to in-depth audits.

- Development of manuals for the execution of selective and integral tax audits of short duration, aimed at detecting fraud and other tax noncompliances.

- Strengthening of the information systems for the internal control prior to, during and after examination.

4. Execution of the Pilot Test

The new system of **Prior Selection for Examination** began to be executed in the region of Zulia in Venezuela starting on August 1st of 2000. For this purpose, it was necessary to condition the physical space intended for summoning and assisting taxpayers selected by the system. Parallel to this, a selection was made of the officials that participated in the test and they were incorporated in a permanent training program aimed at specialization according to economic activity to be investigated.

The procedure for selecting taxpayers began with a comparison between potential collection of each economic sector, by means of the national accounts, with actual collection by each of these sectors, in order to identify those economic activities that are more prone to evasion. Once classified, selection parameters were incorporated in the Venezuelan Tax Information System-SIVIT, which were: fiscal period, region, economic activity, date of fiscal closing and tax. For the systematic segmentation and statistical analysis of the sample SIVIT processed 450,000 returns, obtaining a list of 214 taxpayers who could be examined. The information of the selected sample was transferred from SIVIT to CONGES for the follow-up of each of the cases through examination schedules structured in such a way as to visualize detailed information on each taxpayer in relation to: selection parameters, elements of the Fiscal Information Register, omissions and extemporaneous returns, algebraic errors and body of tax indicators that justified the selection. Each of these examination schedules was transmitted to the region of Zulia via the network, being received by the Head of the Examination Division from that jurisdiction. In turn, he authorized each case and transmitted it to the Summons Coordination Office to begin the first phase of the procedure, characterized by the objective induction of the taxpayer toward an adjustment of the operations reported and the filing of omitted returns, all in a voluntary manner. In this first phase, the following activities were carried out in the presence of the legal representatives of the companies: analysis of data relative to RIF, modifying them on-line, as appropriate; summons of the taxpayer for filing omitted and rectifying returns, by immediately issuing the assessment for tax differences, fines and interest; request for financial statements and other documents that may contribute to clarify the situation of each taxpayer, as well as presentation of the result of the analysis of tax and financial indicators.

Following expiration of the term (25 days) allowed by the Venezuelan legislation for compliance with requirements of the first phase, the subsequent qualitative and quantitative analysis was made, as well as a systematic calculation of the variation of the indicators that activated their selection, allowing the CONGES system, through comparison of the indicators adjusted with the normal values of the same economic activity, to objectively decide the suspension or continuation of the second phase, also known as determination, as well as follow up of the file up to is closing.

RESULTS OF PILOT TEST
REGION OF ZULIA
AUGUST 2000 THROUGH DECEMBER 2000
PERIOD PROCESSED 1996

SELECTED TAXPAYERS	214		100.00 %
SUMMONED TAXPAYERS		142	66.36 %
TAXPAYERS TO BE SUMMONED		72	33.64 %
SUMMONED TAXPAYERS	142		100.00 %
APPOINTMENTS HANDLED		97	68.31 %
APPOINTMENTS TO BE HANDLED		41	28.87%
SANCTION FOR NOT ATTENDING APPOINTMENT		4	2.82 %
APPOINTMENTS HANDLED	97		100.00 %
CASES CONCLUDED FOR IN-DEPTH EXAMINATION		59	60.82 %
CASES CONCLUDED WITH VOLUNTARY ADJUSTMENT		38	39.18 %

Source: CONGES- Previous Selection for Examination, GRTI Zuliana.

The sample processed consisted of taxpayers registered in the region of Zulia (28,692), with 214 selected by SIVIT as capable of being examined, which is equivalent to 0.75% of the region's total. Of the 142 summoned, 97 attended, of which 38 (39%) voluntarily adjusted themselves to the proposals made by the examiners who made the summons. The amount of voluntary adjustment obtained through substitutive returns was Bs. 167,168,777.00. Additionally, 37 taxpayers of the same 97 were sanctioned, for extemporaneous payments, with Bs. 19,346,450.00 including delinquent interests. Shown below are some important considerations in the execution of the test:

- The 4 taxpayers who did not show up were sanctioned with Bs. 2,088,000.00 and it was ordered that they be subjected to audit.
- It is important to note that voluntary adjustments corresponding to the summons phase constitute effective collection, on not being subject to taxpayer appeals or objections at other instances.

- The staff of auditors for the test in this summons phase was formed by five officials that would assist an average of 400 taxpayers monthly, coordinated by a head of area.
- During the five months of execution of the test, a number of taxpayers equivalent to that indicated in the previous item was not summoned due to the training process to which the officials were subjected for mastering the new system used.

In the execution of the test three fundamental limitations were detected, namely: lack of classification by economic activity of the majority of taxpayers processed, since they do not report the CIIU code through the returns filed; insufficient memory capacity for the selection system used, which aspect prevented the simultaneous processing of the returns in different regions, as well as slowness in the processes executed by the users.

Another limitation found in the systematic processing of returns filed by the taxpayer population has been, delay in their transcription to SIVIT, which has prevented access to the most recent information. This situation has promoted the development of a project for capturing information included in the returns through optic reading systems, to thus reduce the existing delay and improve the quality of information.

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Case study:

TOPIC 2.2

THE CONTROL OF INVOICING AND THE SCHEDULING AND EXECUTION OF MASSIVE EXAMINATION OPERATIONS

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CONTENTS: I. Introduction.- II. Traditional Massive Control Procedures.- III. New Focus in the Use of Information for Scheduling and Executing Massive Examinations.- III.1 Invoicing control.- III.1.1 Operations between companies.- III.1.2 Massive sale to end consumers.- III.2 Goods transit control.- III.3 Withholding regimes due to taxpayer differentiation.- III.4 Early Registration Regime.- III.5 The use of notebooks or PDA in the execution of massive controls.

I. INTRODUCTION

Examination tasks must constantly evolve with the purpose of adapting to the new controlling needs imposed by the tax system.

Similarly, the scarse availability of officers to assign the examination task in regards to the universe of subjects to control, is another factor to be considered when designing control procedures that optimize the task's cost-benefit ratio.

On the other hand, currently available information technologies allow tax administrations to establish non-traditional control mechanisms, with the purpose of expanding the examinations' scope and make them more effective.

II. TRADITIONAL MASSIVE CONTROL PROCEDURES

Prior to entering into the analysis of the topic that concerns us, and without purporting to establish a definition regarding the object and the nature of massive controls, it is important to mention that in general they correspond to *preventive actions that attempt to raise the awareness in taxpayers of the risk of being detected and sanctioned for their non-compliance, directly acting on formal issues and, later on related materials as a subsequent effect.*

Said preventive actions generally have a dissuasive nature and are not translated into examination adjustments, but rather tend to extend the "risk effect" produced in taxpayers when they closely perceive the action of the Administration.

An example of this, are the traditional "tracing" operatives were punctual examinations are performed on the invoicing and registration of operations regime, or directed to detect non-registered workers. The essential characteristic of these operatives is that they are circumscribed to a limited geographical scope and reaches most taxpayers belonging to the same. During the last month of the summer season (January 2001), over 5,000 examinations of this nature were performed.

Preventive 'fixed points' are another clear example, these are where taxpyers' activities are registered for two or three days, in order to have a pressumed base of the taxpayer's monthly activities levels. Such procedures are applied to different taxpayers consecutively, in a determinate zone or activity branch (for example: during summer season to restaurants in tourist areas). During January 2001 and only in determinate tourist areas, around 600 preventive fixed points were performed.

From the above we can see that through merely formal controls evasive behavoirs are deterred, thus improving compliance on behalf of examined taxpayers, as well as from taxpayers around them, which perceived the development of the control actions on behalf of the administration.

However, the application of controls of this nature requires the ample use of human resources. It is obvious that it is the case of physical control involving the presence of tax officials, which may affect entire examination units, in the event of having the intention of covering a large zone.

Similarly and in general, control tasks do not end with the examination involving the presence of tax officials, the rather the information is transferred to the administration's headquarters for processing.

On the other hand, management control in this case results limited since it is not easy to assert a determinate effectiveness guideline that measures the efficacy of the examination or the auditor. We must bear in mind that collection is not obtained due to adjustments in the taxpayer's return, rather a determinate behavior is induced.

The characteristics of controls of this nature are summarized according to the following detail:

Preventive type actions

Applicable to basically formal issues

Difficult evaluation of the results

Seek an exemplary effect

Intensive use of personnel, by means of the presence of tax officials

Limited scheduling possibilities

III. NEW FOCUS IN THE USE OF INFORMATION FOR SCHEDULING AND EXECUTING MASSIVE EXAMINATIONS

The framework of restrictions where the Tax Administration generally performs makes indispensable the rationalized use of the resources available.

In the same manner, technological evolution in information technologies and in telecommunications facilitates the link with taxpayers, as well as the Administration's tasks, which brings about constant adaptation examination programs.

In this regard, the encumbrance of resources is sought to be avoided by favoring preventive actions with scarce prior scheduling and on the contrary, direct preventive actions towards the higher-risk taxpayer segments or point it towards previously obtained information.

In this order of issues, for some time now the AFIP has undertaken an adaptation process on the manner in which massive control scheduling and execution procedures are carried out, based on the following action lines:

- The establishment of simple information regimes or authorization regarding formal requirements, which facilitate the application of massive controls.

- The application of differential treatment for 'non reliable' taxpayers in order to encourage them to improve their tax behaviors.

- Increase in the application of massive controls by using more 'reliable' taxpayers as the core of the preventive action.

- The use of technological tools that simplify and facilitate controls.

Though some of the aforementioned action lines imply new obligations for taxpayers, an attempt was made to adapt currently existing obligations through the application of simple information technology procedures that avoid the conjunction and nuisance of personal transactions at the administration's office.

In parallel, the Administration is incorporating information technology tools that allow examiners performing field tasks, to have access to information available in databases during the execution of massive operations, in a simple manner, without requiring technical training on behalf of personnel operating the same.

In this new modality, the significance of the operations is not defined based on geographical criteria or by taking into consideration seasonal activities, but it is more directed towards the identification of irregularity patterns committed by taxpayers.

In this context, and different from traditional controls, a more objective result is sought, be it in the change of behavior of the person being examined (regularization of his/her situation) or in the application of a concrete restriction (more burdensome withholding, authorization for lower invoicing, etc.), since actions are applied on the irregularities detected.

Hereinafter we shall develop the main aspects being advanced by AFIP, in reference to the scheduling and execution of controls related to invoicing, as well as interaction with other concepts.

III.1 Invoicing Control

In the framework of the invoicing and operations registration regime currently in force in our country, basically two different worlds of operations to be controlled are distinguished:

Operations between companies

These are companies that generate the right to compute tax credits in VAT, in addition to deductions (Class 'A' Invoices). In this regard, one of the main objectives is to fight against the use of false invoices.

Operations performed with end consumers are also included in this group of operations, when the same constitute a minor proportion when compared to the total invoicing of the taxpayer responsable.

For operations of this nature the Authorization Control for the Printing of Invoices System is used, the same reaches over 740,000 responsable taxpayers subject to VAT.

Massive sales to end consumers

Persons that perform massive sales to final consumers, are obliged to use the equipment called "Tax Controller", which allows to have better control on the operations registered therein. In this case, the objective is focused towards fighting sales exclusions.

III.1.1 Operations between companies

Background

Taking into consideration the fact that the use of apocryphal (alleged) invoices constitutes one of the most developed forms of evasion in our country, and in order to reduce their use, the need to control the production process of vouchers was laid out.

Starting from the concept that invoices have a nature similar to that of checks against the Treasury, since they have tax credits which amounts will be deducted from the tax to be input by the taxpayer. In such regard, control points on the production of these kind of “checks” were established, pursuant to the following detail:

a) Tax Registry of Printing Shops
Only companies registered in the AFIP are allowed to produce Class “A” invoices (containing VAT tax credits). Therefore, said subjects must observe regular tax behavior and comply with determinate additional requirments, such as municipality qualifications in the capacity of printing shop, and have no penal crime record, causes, etc.

At 31/01/2001 the AFIP has registered over 6,300 printing houses qualified to produce invoices.

b) Prior Authorization through Internet
The production of invoices requires prior authorization from AFIP, which is transacted directly by the printing shops registered through Internet, in a systematized ‘on line’ transaction which operates 24 hours a day, every day.

Once the AFIP recieves an application to print invoices, it authorizes a determinate amount of vouchers by assigning the corresponding numbering, in function of the taxpayer’s tax behavior. That is, when there are determinate formal non-performances, mainly the omission in presenting tax returns and not updating the declared domicile, the system authorizes an amount less than that originally requested by the taxpayer.

Likewise, in the event that the taxpayer is not registered or is not authorized to issue invoices with tax credits, the AFIP completely rejects the application.

It is important to point out that the proceedings for an authorization is not a complex process for the printing shop entrusted with the job, or for its customers and the system performs the evaluation in a few seconds.

As an example, it is important to mention that authorizations automatically granted by the system at the beginning of the regime - 1/08/1998 - until 31/01/2001, add up to over 3,160,000, which represents a monthly average of

approximately 105.000 authorizations. From that total, a percentage around 80% were granted without restrictions, while the rest of the cases were assigned less invoices than the amount requested (from 5% up to 90% of the original order).

c) Expiration Date
Authorized invoices have an expiration date (one year maximum) assigned by AFIP when the authorization is granted. The date granted is also linked to the tax behavior of the applicant and is proportional to the amount of authorized invoices.

It is important to mention, that the use of expired invoices does not generate the tax credit computation rights contained therein.

d) Information Regime
Registered printing shops must monthly report through the Internet, the delivery date of the invoices produced during that period. In this manner the moment in which the invoices are in circulation is known.

New aspects considered in scheduling and executing massive controls

In a complementary manner to traditional controls and having prior information pertaining to the detail of the authorized invoices, their numbering and expiration, the audited printing shop iand the result of the authorization, it is possible to establish controls, as from the identification of determinate irregular situations, some of which are described hereinafter:

a) Massive control of authorized invoices
Stored information pertaining to authorized invoices in turn serve as a base, for other control systems implemented by AFIP based on the examination of the computation of the VAT tax credits, such as VAT returns for exports or information regimes of purchases performed by the most important taxpayers. In the same, released vouchers are verified with the authorizations taxpayer roll in order to confirm their validity as such.

b) Taxpayers with expired printing authorizations or without authorizations
It is possible to detect cases where taxed activities are developed, this is verified by the taxpayer's filing of the income tax return, without the supporting documents in proper conditions. It is possible in such circumstances to centrally send a notice, and then verify with the invoicing database the regularization of the anomaly or preform an examination with the presence of the official at the taxpayer's domicile.

It must be considered that actions of this nature make more sense at the beginning of the regime and this results to be innovative. As an interesting piece of information we can mention that during the first control performed, the selection of taxpayers showed around 48,300 cases, the same were notified through mail.

After a reasonable term, the selection was once again performed, the result was less than that obtained during the first term – 8,700 cases -, with which we can presume the result of the method.

Said operative, besides from achieving that examined taxpayers remedied the anomalies detected, allowed to correct inconvenients with the declared domicle in approximately 4,700 cases.

c) General invoicing controls
Considering that invoicing constitutes the documentary registry of operations subject to taxes and notwithstanding common formal controls, it is possible to advance towards other more concrete aspects, such as the examination of taxpayers with minimum or null tax debits (VAT from sales) or directly without movements, and which at the same time register invoicing authorization requests in amount that pressumably would indicate another tax situation.

It is important to mention that during the year 2000, 53,300 examinations related to invoicing were performed in the aformentioned manner.

d) Control of the declared domicile
Related to what has been state regarding the existing inconvenients in the update of domicile, automated massive control directed to 'correct' diversions of this nature was defined. The same consists in sending to the declared domicile, an acess key (password) that shall be introduced during the next printing authorization requested, without which the same may not be transacted. Therefore, if the correspondence does not arrive to its destination, the taxpayer must personally visit the AFIP agency to obtain the datum in question, prior to updating the domicile.

In the application of this procedure, the world of subjects to reach must be planned through segmentation or by foreseeing the total thereof. To date and due to budgetarty issues, this procedure is applied to determinate taxpayer segments which change annually. To date 16,000 documents with the key in question were sent, of which 4,000 forced the taxpayer to update his/her domicle.

e) Taxpayers with reiterated partial authorizations
In these cases we denote the lack of intention on behalf of the taxpayer of regularizing the filing of omitted tax returns or in updating the tax domicile, which could reveal irregular behaviors in the use of invoices, or in the general compliance with the obligations under the taxpayer's responsibility.

In this regard, it is important to mention that around 23,800 cases were detected, in which over 5 partial authorizations were registered.

Concerning what was indicated in items b), d) and e), examination areas have said information whenever the same is required through transactions developed to this effect, with the purpose of selecting the issues, which according to its judgement reveal greater interest.

In the same manner, auditors that perform examinations in greater detail – non preventive – have available invoicing information to be used in the validity control of tax credits computed by examined subjects (for VAT adjustments, refund controls, etc.)

The invoice authorization procedure, also results to be useful for taxpayers who wish to verify the validity of the vouchers received, since a query has been developed for such purposes in AFIP's WEB page.

III.1.2 Massive sale to end consumers

Background

Another important sector to be controlled is constituted by subjects that perform massive sales to end consumers. Even though said sales individually represent small amounts, the considerable amount of operations performed make their control difficult.

Similarly, the lack of interest on behalf of the operation's counterparties – end consumers – in receiving vouchers since the same do not represent tax benefits, favors the possibility that these transaction be channel through a marginal circuit, through the annullment of the operation or sales omissions.

In this regard, the use of "Tax Controllers", which are invoicing equipment similar to cash registeres or printers that can issue tickets or invoices .

The main characteristic of these equipments is that they have EPROM memory where the total sales per business day are stored as well as the taxes contained in said operations. This "tax" memory cannot be erased, and constitutes a base to estimate the return on behalf of taxpayers.

It is important to mention that the operaiton of the tax controller does not differ from that of the cash registers or traditional printers, though in this last case adaptation is required from the taxpayer's invoicing systems.

We can also point out that the equipment have a serial port solely assigned for the purpose that AFIP auditors may obtain the information contained in the tax memory whenever they require the same. Such circumstance may be carried out by any auditor provided that he has a notebook computer and the software developed by the AFIP for such task.

In the application scope, this regime does not create an overlay in the system described in the previous item, but they complement each other upon procuring control in different operations.

Companies that have the intention of dedicating themselves to manufacture or distribute these equipments must register in AFIP, therefore, requirements such as 'tax reliability' and good financial standing are required, furthermore, in the case of defaults additional tax obligations are imposed and strong sanctions are applied. Currently there are around 20 suppliers registered, and they have comfirmed the registry of 48 equipment in the AFIP.

On the other hand, whoever installs Tax Controllers must make evident such situation through the one time presentation of a simple form. Said data shall be compared with the information coming from suppliers, which must inform AFIP, the detail of the tax contollers montly installed. Currently over 140,000 tax controllers are installed.

New aspects considered in scheduling and executing massive controls

Based on the information provided in the foregoing paragraphs, control actions such as the following may be programmed:

a) Data collection from tax controllers
   Based on a programmed selection (by installation chronogram, economic activity, etc.) data from the tax controllers installed are extracted to form a database to estimate the tax debit to be filed, the same cannot be less than the value that comes from the tax equipment. Therefore the information obtained from the controller is verified with the sales declared by taxpyers in the VAT.

   The data extraction procedure will be explained with greater detail in item III.5, where it is mentioned that, during the operative performed on January 2001 exclusively in tourists areas, it was practiced in over 1,100 tax controllers.

b) Under obligation without tax controllers installed
   Taking into consideration that it is possible to identify under obligation through the economic activity stated in the

taxpayer registry, it may be determined – in principal – who are in omission. The first comparison of information reflected results around 12,000 subjects without information regarding the installation of the tax controller.

c) Controllers without replacement invoices
Considering that it is mandatory to have replacement invoices to face the event that a controller may be damaged, it may be easily determined who did not request the printing authorization of said vouchers or who does not have an authorization in force (not expired). The latest piece of information obtained in this regard amounts to 3,100 cases.

III.2 Goods transit control

Background

The transit of goods constitutes apoint of interest for control, since it is produced in declared as well as marginal sales. The most commong evasion forms in this regard are circumscribed to the transfer of assets without the corresponding documentation, with false vouchers or well by the use of one document on repeated occassions.

According to the standards in force, most transfers must be documented with the invoice or with the delivery. The latter must comply with determinate printing formalities, though not with the prior authorization requirement stipulated for invoices.

When the prior authorization procedure for deliveries was not at hand, document road control was limited to formal aspects and tied to “ex-post” mechanisms for capturing and processing released information.

Due to the above reasons, towards the end of the year 2000, deliveries used by the responsable taxpayers registered in the VAT must be authorized by the Administration, in te same manner than invoices, in order to broaden their control possibilities.

New aspects considered in scheduling and executing massive controls

Once the registry of deliveries and authorized invoices was formed, remote access mechanisms for said information were developed to perfom on-line controls, pertaining to the validity of the data inquired and the detection of multiple uses. Therefore, the inquiry of vouchers intervened in transit were developed, which foresee the automatic storage thereof.

It is important to mention that according to recent experience, the surprise of the carriers produced by the immediate examination of the conditions of the vouchers used was percieved, we estimate that - in the future - this will cause an increase in the perception of the risk.

This system is in its primary installation stage and during the month of January 2001 over 800 remote inquiries were performed, of which around 330 revealed irregularities (invalid documents or multiple uses).

Regarding the means used to perform the inquiries mentioned, the same shall be explained in item III.5.

III.3 Withholding regimes due to taxpayer differentiation

Background

Traditional withholding regimes have as a main objective to advance and assure collection in determinate operations, but in general they do not help to improve tax compliance levels in withheld subjects.

By using Internet facilities a query system was defined to be used by withholding agents, in order to incorporate a diffentiating principal from the different withheld subjects, based on the evaluation of their tax behavior.

An attempt is made to increase withholding in subjects that the Administration has little hopes that they will input the tax generated in the corresponding operation.

Withholding personnel must monthly consult the tax situation of each taxpayer subject to withholding, in order to apply the withholding differential aliquot in function of the answer obtained. Said answer consists of a code per each inquired subject, the same reveals his/her tax situation, which may lead – in the worst of cases – to withhold 100% of the tax contained in the operation.

Said Internet query may be done individually (subject by subject) or through the delivery of a file containing the list of all suppliers. In both cases, the response takes place in seconds and returns the inquired data with the corresponding qualification.

The qualification is valid for one month. However, there is an exception procedure, whereby the same may be modified, only in the event that the withheld person regularizes the returns owed.

This means that if a taxpayer does not result to be “reliable” the totality of the tax is withheld, leading him/her to improve his/her tax behavior in order to not be withheld for the same amount in future operations.

In this manner the control of returns is sought to be made “massive” by delegating it to third parties through withholding agents, by means of the use of a simple procedure.

New aspects considered in scheduling and executing massive controls

Massive control is exercised by over 1,700 withholding agents whenever they receive invoices coming from a responsible taxpayer registered in the VAT which in such condition may generate tax credits in operations. During the month of January 2001 the group of withholding agents, inquired almost 568,000 suppliers.

In this regard, the system classifies the supplier from the withholding agent, according ot the following breakdown:

a) Subject registered that does not register ommission when filing returns.
   In this case the withholding agent must withhold a determinate percentage from the tax contained in the operation. During January 2001 260,000 taxpayers were registered with this response.

b) Subject registered that registers omissions when filing returns.
The withholding agent must withhold 100% of the tax contained in the operation. During January 2001 this circumstance was observed in around 108,000 cases.

c) Subject not registered in the VAT and without authorization to use invoices.
The withholding agent may not compute tax credits in the event of receiving the invoice, as it was registered in approximately 200,00 cases during January 2001.

d) Subjects with problems detected in the marketing chain.
If in any examination an irregularity is detected in the computation of tax credits, such circumstance is entered into the system as a novelty that reveal inconveniences in the marketing chain of the examined subject as well as in the taxpayer with whom they perform operations.

Int this manner examinations provide feedback to the withholding system updating the same on determinate irregularities, in addition to preventing simulated marketing schemes created with the effect of reducing the tax burden.

This situation has treatment similar to that granted to registered subjects that register ommissions (item b).

III.4 Early registration regime

Background

A common activity that obstructed examination actions which consisted in that when an employee that was not declared was detected, the employer argumented that this employee had been recently hired and was to be included in the return that expired on the month following the examination.

In this context, the employee was declared in the month when the control was performed, therefore the examining action did not produce a corrective effect.

New aspects considered in scheduling and executing massive controls

As a first measure the obligation that employers, prior to the beginning of the labor relation, shall grant the “early registration” of the employee with an indication of the date of entrance of the same and the social work and corresponding ART.

In this manner, if an employee is detected without the corresponding early registry, this circumstance constitutes a violation itself and enables the AFIP to use determinate pressumptions to determine the date on which the labor relation began.

In addition to qualfying pressumptive means, the on-site examination generates the opposition of interests between the employee and his/her employer, upon linking early registration with health care social assistance and work related risks. In this regard, social works and insurance companies turn into AFIP allies.

It is important to mention that the aforementioned early registration is done through a simple transaction available through the Internet, which in turn facilicates – through the same means – timely examination thereof, on behalf of the auditor or the employee interested in the case.

From the beginning of the system over 100,000 employers transacted 760,000 early registration, of which almost 2,300 did it through the Call Center.

With a simple procedure AFIP was given greater capacities for the control of provisional evasion, without this meaning the imposition of bothersome procedures for the employer. As an example of this, during January 2001 over 7,400 employees were released, only in the tourist areas, detecting over 1,500 not declared.

III.5 The use of notebooks or PDA in the execution of massive controls

In the execution of massive controls, the use of technology constitutes a relevant support factor, since it simplifies examination associated tasks.

In the same manner, the fact that auditors are able to inquire the Administration's databases from any point, be this the taxpayer's domicile or in a road corssing, this produces in the individuals examined greater sensation that the Administration has information on him/her, increasing his/her risk perception.

Control mechanisms that use technology elements for their execution such as notebooks and wireless connections are explained hereinafter:

a) Data collection from tax controllers
This task – described in item III.2 is done by means of the use of notebooks connected through a serial cable to the corresponding port of each tax controller. Portable PCs have software developed by the AFIP that may be used by any auditor.

b) Road and Invoicing Control
In these cases, a notebook connected to the Internet through a data transmission interface (such as cellular connection that uses a trunking system or PCS or satellite) is used, by virtue of which updated information may be immediately consulted.

As previously mentioned, inquiries performed on-line and their replies are automatically stored therefore, later data input management at the offices was eliminated, and this allowed the detection of multiple use vouchers.

In this type of control, we can immediately determine if released vouchers are valid (they have AFIP's authorization), if they are in force (not expired), if the consigned residential data correspond to the registered subjects, if the tax controller installed is declared, if it corresponds to equipment confirmed by the AFIP, etc.

c) Early Registry Examination
By using the same equipment mentioned in the foregoing item, it is possible to verify the early registry at the same time that personnel is relased.

Within the functionalities of the inquiries developed, the complete list of subjects early registered may be verified in the firm examined,

the date on which the early registration took place, if the employees are declared by more than one employer, etc. or grant the early registration by operation of law by the the auditor.

It is important to mention, that operation tests for the use of personal organizers (PDA or Palmtops) are being carried out to replace notebooks, due to less costs and greater portability.

IV. CONCLUSIONS

Once we have described the new approaches to direct, simplify and make more effective massive examination operatives being used by the AFIP, it is possible to summarize the advances obtained when compared to traditional examinations, as indicated hereinafter:

- Basic scheduling of operatives essentially sustained in the geographical scope of the control, activities to be considered, personnel to be assigned, etc., is being complemented by the orientation of the examination actions in function of information specially requested or by detected irregularities.
- Currently the control of the formality allows to reach material issues, without reasigning the agility of the traditional modality. In such sense the following may be mentioned:
- In the case of invoicing, it is possible to invalidate computed tax credits as from invoices with irregularities.
- In the case of the tax controllers, obtaining information allows to establish the minimum tax debit to be declared by the taxpayer.
- It is possible to delegate controls to auditing third parties, as in the case of invoice authorization through printing shops and inquiries from suppliers by withholding agents. In this manner it is possible to substantially broaden the world of subjects submitted to said controls, granting differential treatment by taxpayer upon establishing restrictions for “non-reliable taxpayers.”
- In the same manner the simplification of tasks takes place upon avoiding the duplicity of determinate actions. In the case of road control and invoicing, inquiries performed are automatically saved and are available for on-line use.

- The possibility of performing on-line queries regarding the examined taxpayer's situation, improves the opportunity to detect irregularities and act thereon.

Even though advances were registered with the use of the new massive examination approaches, we continue to use traditional methods because they cannot be abandoned due to the presence of the AFIP in certain sectors of the economy, geographic areas or during yearly seasons, where peaking levels are registered in economic activities.

Without detriment thereto, AFIP continues evaluating the possibility of extending the application of new approaches in areas related to invoicing as well as in other areas that are of greater interests (deliveries in agriculture – cattle activities, container transit control, revenue tax withholding, examination of specific registries, etc.).

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Case study:

TOPIC 2.2

THE CONTROL OF INVOICING AND THE SCHEDULING AND EXECUTION OF MASSIVE EXAMINATION OPERATIONS

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1. INTRODUCTION:

Massive Controls of Tax Compliance

The examination function, defined as a series of actions carried out by the Tax Administration for verifying tax compliance by the taxpayers, and detecting the various forms of evasion, should not only endeavor to normalize such situations, but also to create mechanisms that may maximize taxpayer voluntary compliance. This aspect is achieved by increasing the potential and effective risk for infringers.

It is known that there are different forms for acting in such sense, by applying not only repressive and sanctioning actions, but also preventive ones. In this latter aspect, tax compliance massive operations and controls perform a very important role.

We may define operations as *examination actions undertaken by the Tax Administration which have a partial scope, with an important preventive component and which imply massive control of a group of taxpayers selected through various criteria, such as: geographical, lines of business, date of balance, for having ratios below values determined according to the activity they carry out; etc.*

In Uruguay, as in most of the countries of the region, there is a pyramidal composition of tax collection and it is thus that a reduced percentage of companies contribute the core of collection, while, on the other hand, a large number of taxpayers contribute a low percentage of total revenues. It is important to apply massive tax control methods to this group of businesses which is very large.

The following chart shows the situation of Uruguay in this aspect, through January 2001:

TAXPAYER STRUCTURE	AMOUNT	%	%COLLECTED OVER TOTAL COLLECTION
Large Taxpayers	10,435	6	84
Medium and small taxpayers	177,287	94	16
TOTAL ACTIVE TAXPAYERS	**187,722**	**100**	**100**

For reasons of tax equity and justice, all taxpayers must feel the possibility of being examined. The examination plans must create a high potential of risk for the eventual evader, that may increase the subjective consideration with respect to the possibility of being detected and sanctioned and, accordingly, that may discourage tax evasion.

To achieve this objective, there should be a combination of in-depth examinations (basically large taxpayers) with speedy examinations of small and medium sized businesses so as to cover the taxpayer universe. This should be complemented with massive tax compliance operations or controls.

2. TAX REVENUES STRUCTURE IN URUGUAY

Tax Revenues Structure
1998 - 2000
(figures in thousands of dollars)

TAX	1998		1999		2000	
	U$S	%	U$S	%	U$S	%
VAT	1,952,453	54	1,773,256	54	1,644,018	53
IMESI	723,131	20	623,923	19	620,384	20
IRIC	470,035	13	426,895	13	434,269	14
NET WORTH	180,783	5	131,352	4	124,077	4
OTHERS	289,252	8	328,381	10	279,173	9
TOTAL	**3,615,654**	**100**	**3,283,807**	**100**	**3,101,921**	**100**

As may be seen, the most important tax is VAT, which concentrates over 50% of total tax revenues. To adequately examine this tax, it is essential that there be tax rules that provide for an adequate system of invoicing and registration, that may force taxpayers to document operations they may carry out according to certain requirements. Mass examination operations, fulfill an important role in ensuring that these aspects, linked to invoicing, be correctly made.

Some rules related to invoicing will be analyzed under the following item.

3. RULES ON INVOICING

3.1 Obligation to Document Operations

In Uruguay, rules governing the obligation to document operations that generate taxes are basically found in Decree 597/88 of 09/21/88 with the drafting provided by Decree 388/92 of 08/17/92, which obliges individuals subject to taxes administered by the General Directorate of Taxation to document their operations in relation to the taxes that encumber them. The aforementioned operations will be documented in invoices, slips, debit notes, credit notes or equivalent vouchers and should include the following elements:

a) correlative numbering: it should be unique and consecutive for all the documentation, beginning with Nr.1 Series A, and be correlative and progressive until exhausting 6 digits;

b) print shop note: will provide data about the printing shop and must have the printing date, issuance with specification of the initial and final number, number of copies printed and record number to print documentation (which aspect will be subsequently developed);
c) commercial name, if any;
d) trade name;
e) fiscal domicile;
f) registration number in the Taxpayer Master File (TMF) or equivalent;
g) type of voucher;
h) destination on each way; the documentation should be issued as a minimum in 2 copies, with the original for the purchaser, and one for the issuer, who must preserve them correlatively ordered, during the statute of limitations of the taxes that encumber their operations.

To standardize and facilitate control, a Resolution indicates the location of each of these elements as well as the minimum measures some of them should have.

The duration of the documentation is a maximum of 2 years.

Parallel to this, there is the prohibition of having in commercial establishments vouchers that do not respond to the established conditions.

When documenting operations one must establish:

a) the date of issuance;
b) detail of the goods or services rendered with indication of the physical amounts, unit and total price, differentiating the VAT when appropriate (in sales to end consumers, breakdown of VAT may be disregarded).
c) Purchaser's name, domicile and number of registration in the Taxpayer Master File (in case it is a company). If the documentation lacks these elements, the purchaser may not deduct the tax credit in his sworn return.

3.2 Special Invoicing Systems

Taking into account the characteristics of the taxpayers and/or their line of business, as well as technological advances in relation to equipment, alternate invoicing systems are anticipated, which may be grouped as follows:

a) Cash Registers

Its use is allowed for specific lines of business, namely: drugstores, bars, ice cream parlors, bakery shops, etc. There are some specific requirements such as: numerator of operations and repositioning to zero that may be inviolable; control copy that should be a true copy of the tickets delivered and grand total.

Prior to its use, a Sworn Return with data thereof should be submitted to the office of the DGI, which should be accompanied with a voucher issued by the company that sold the Cash Register.

b) Computerized systems

Those issuing invoices with this equipment must not request previous authorization, but the documentation issues must fulfill all the requirements indicated in item 3.1, except for the possibility of replacing the mention of the type of document in a preprinted manner by the print made by the computerized equipment.

The number of copies must be standard for every type of document and a control table must be maintained for correlating the amount and numbering of the documents issued for each type (including those annulled), with the amount and number of the forms used.

c) Point of sale terminals

The technological advance caused the need to regulate this modality of documenting operations through the use of point of sale terminals, by issuing the documentation in pre-printed forms in rolls of paper of fixed or variable length.

The regulations provide, among other elements, the following control mechanisms:

i. the rolls must be numbered correlatively
ii. the system must print on each document: the type of voucher, the correlative numbers according to the general documentation standards, and the number of the roll being used.

iii. print jointly with the original roll, a control tape or audit tape that should be a true copy of the first one;
iv. issuance by the system at each working station, of a daily report at the closing of operations, indicating the data relative to the sales made on each shift;
v. prepare daily and at each tax domicile a consolidated summary of the total operations carried out through the system. This should be issued on a pre-printed form and be preserved for the term of the statute of limitations of the taxes.

3.3. Printing Shop Regime

Prior to printing the documentation, the taxpayers must request the Administration for the issuance of a numbered certificate, without which no printing shop may perform the work. Parallel to this, there is a register of authorized printing shops, which will be the ones carrying out the printing of documents and informing the Tax Administration on a monthly basis, about the work performed for each taxpayer.

These elements allow the Tax Administration to have the information on real time from all the companies that have requested certificates. This, complemented with the information from the printing shops relative to the documentation issued by each taxpayer, are basic elements for carrying out specific controls. It is thus possible, for example, to crosscheck requests for certificates to print documentation and payments made by the companies, and be able to promptly detect delinquent companies. On the other hand, based on the analysis of the number of the documentation issued and reported by the printing shops, one may have an initial idea about the taxpayers' activity and there may also arise an eventual duplication or any other irregular situation.

The need to request for a certificate in order to print documents is also of great usefulness in order to have updated the registration data, in particular the tax domiciles of taxpayers, since such domicile is included therein and it is the only one that may appear in the documentation. It also allows for determining which are the active companies, since, as previously established, the maximum term for using the documentation is 2 years.

3.4. Possibility of Closing Businesses

An important tool available to the Tax Administration in its struggle against evasion, is the power to undertake before the competent jurisdictional entities, the closing of businesses for up to 6 working days, whenever they may violate the rules about documentation of operations.

In fact, closing may take place in the following cases:

a) making sales or rendering services without issuing invoice
b) writing invoices for an amount lower than the real one (underinvoicing)
c) violation of the general documentation regime

4. STAGES IN MASSIVE EXAMINATION OPERATIONS

Four main stages may be identified in massive examination operations:

I) Determination of objectives.
II) Scheduling.
III) Execution.
IV) Evaluation.

4.1. Determination of Objectives

In general, in a massive tax compliance control plan several objectives are pursued, which may be divided into two large groups: general and specific. The general objectives, as its name indicates, are objectives that set in most operations, while the specific ones are particular for each operation.

General objectives:

i. **Increase in taxpayers the expectation of risk of being examined,** since a larger number of actions are being covered. In this way, improvement of voluntary compliance with tax obligations is being sought.

ii. **To be a selection instrument,** with a view to carrying out in-depth examinations in those cases where there is presumption of noncompliance with tax obligations.
From the controls undertaken the auditor may obtain an initial impression of the company's tax behavior and, accordingly, be able to detect taxpayers who apparently pay less amount of taxes than they should.

iii. **Verification of Taxpayer File data.**
In fact, the massive visit to taxpayers is an excellent opportunity for clearing and correcting identification data in the Taxpayer File. It is particularly important to ensure that the activity carried out by the company agree with that shown in the TMF since, for example, the ratios obtained by the Tax Administration for analyzing the taxpayer sworn returns are grouped according to line of business. If this is incorrect, in many cases the analysis is invalidated and erroneous conclusions are reached.

Specific objectives:

Are those depending on the type of operation.

By way of example, the following may be established:

- Verification of compliance with formal obligations, in particular the issuance of sales documentation, in a specific zone.
- Detection of unregistered taxpayers through zone controls
- Ensuring that the sales documentation agree with that declared in the sworn returns
- Ensuring that the Purchase VAT deducted agree with the respective documentation, and that it latter comply with formal regulations and correspond to necessary acquisitions for obtaining and preserving income
- Control of delinquency in businesses requesting certificates for printing documentation and have no payments.

4.2. Scheduling

The respective scheduling will be made in accordance with the objectives determined for the massive control operation to be undertaken.

This is a fundamental stage of the operation. It must be borne in mind that if an operation is not adequately scheduled, one may achieve negative or even contrary results to those being sought. For example, an undue control of compliance with formal obligations or similarly, a control of tax credit (that is, VAT on Purchases deducted by the taxpayers) which does not detect the existing fraud, transmits an image of inefficiency of the Tax Administration and instead of improving voluntary tax compliance, the contrary effect is achieved, since it reduces the evading taxpayer's perception of risk, which leads him to recur and even increase evasion.

At this stage, the following aspects are analyzed, evaluated and projected:

a) the different actions to be carried out and where they will be held
b) the procedures to be applied
c) the time it will be done and the estimated duration of the operation
d) the officials that will participate therein

With respect to the officials, massive control operations have the disadvantage of requiring a large staff, but on the other hand, they have the advantage that in many cases such staff need not be very qualified.

It is important to train the staff devoted to this task and to establish instructions clearly reflecting the objectives sought and the procedures to be applied.

At this stage, it is important to handle with the greatest reserve, the zones or companies that will be controlled, in order that the surprise effect may adequately operate in the subsequent stage of execution.

To carry out the examination task, it is essential to count on all the duly processed information available in the Administration. That is,

by way of example, computerized tax file of the taxpayers to be visited, their registration data, type of activity, company officials, taxes to which they are subject, payment thereof, etc.

There should be a clear outline of percentages of yield or performance indexes of the examination items that may be measurable and objectively achieved.

4.3. Execution

At this stage, examination officials visit the enterprises and the following aspects may be distinguished:

a) **Implementation of controls established in the schedule.** It must be borne in mind that, at this stage, the surprise factor may in many cases be a basic element for the success of the operation. In massive plans and operations, it is important to obtain, at the time of the visit, evidence of irregularities or omissions by the taxpayers, which will afterwards become important elements for an eventual reassessment of taxes and for the application of a sanction (such as the partial closing of the establishment for up to 6 days).

   For example, the surprise factor is basic for detecting:

   - documentation that does not comply with the requirements provided in the rules
   - double set of slips
   - undocumented sales
   - staff in irregular situation, etc.

b) **Data Compilation.** All of the company information will be obtained as provided in the instructions designed in the schedule. For such purpose, it is convenient to design forms that may facilitate and organize the task and then allow for better processing and analyzing such information.

   Likewise, complementary forms may be designed for compiling information. For example, for operations involving the examination of deducted VAT on Purchases, a form has been designed for taking note of all the documents calling

the auditor's attention, in order to subsequently undertake specific controls that may even reach the crosscheck of said documentation.

c) **Preparation of Records.** If irregular elements are found, it is essential to prepare records to leave evidence thereof, by describing such irregular aspects in a clear, complete and objective manner. For example, records support the elements that are the basis of eventual actions involving the closing of businesses.

4.4. Evaluation

Massive examination operations generate a wealth of information as a direct consequence of the fact that, in little time and for many taxpayers, various aspects are controlled. The great technological development of recent years allows for optimizing the processing of such information, which is done faster and in a more complete fashion, by facilitating and rendering more effective the evaluation task.

An analysis is made of all the information obtained, with a selection of cases wherein it is appropriate to continue with the action, either to apply sanctions or to perform complementary controls or a reassessment.

In addition, the adequate administration of such information will be the raw material for carrying out new operations.

The conclusions of the operation may be divided into two main groups:

i. Specific evaluation with regard to the achievement of the objectives sought, as well as of the taxpayers' behavior and performance of the assigned staff (critical and statistical analysis of results).

ii. Extension of the evaluation to more generic issues of subsequent use by the Administration (for example, adaptation of a regulation in force following a reality evidenced in the operation).

5. PRACTICAL EXPERIENCE OF URUGUAY IN MASSIVE EXAMINATION OPERATIONS

In the past years, various massive examination operations have been undertaken in our country. In all cases, after the competent authorities have determined the objectives, the Operational Planning Department of the DGI's Examination Division prepares the respective schedule by writing the corresponding instructions.

The most common operations held in the past years have been the following:

a) Zone control of compliance with formal obligations, particularly the obligation to document sales

For this purpose, the zones selected were basically those of high commercial concentration so as to generate a broad multiplying effect.

On many occasions, since these were door-to-door visits, they also included the objective of detecting unregistered businesses.

In most cases, the auditors counted on the information on the companies existing in the zones with registration data, in order to also verify whether such data were correct.

In all cases, a form was designed for internal use to compile the data from the companies and summarize the results of all companies visited (with and without observations).

When the auditors visit the companies, they verify, among other things, the following aspects:

- that the sales documents are adjusted to the legal and regulatory standards
- that there is no double set of slips
- that the company documents all its sales
- that there is no underinvoicing

To verify these last two items, in some cases proof of cash is made.

As a result of these actions we have that approximately 20% of companies were not located, while another 20% showed some

irregularity or observation. Companies not located are immediately prohibited to print documents, while efforts are made to locate other companies, which the owners may have.

Also, in many cases, these controls generate the request before the jurisdictional entities, of the closing of the commercial establishment, which is an important tool for discouraging tax evasion.

b) Control of taxpayers that requested certificates for printing documents but did not make payments

Consists of selecting taxpayers who, having requested certificates for printing documents, do not comply with their obligations to pay and file sworn returns.

Technological advance has facilitated these controls, and allowed for promptly detecting the companies that are in this situation.

This type of operation aims to determine whether or not the taxpayer is active. If so, one proceeds to regularize his situation. If he is not located, the procedure is the same as that indicated in the previous item.

As statistical data we may indicate that in the 1995-2000 period, the number of companies visited in these two operations was 12,300, which represented approximately 18% of Examination actions. In turn, direct collection resulting from these actions represented 5.6% of total collection obtained by the Examination Division.

c) Control for ensuring that declared sales agree with the documentation

This type of operation, in many cases, complements the controls in relation to sales carried out under item a). In fact, one has confirmed the existence of companies that document all their sales (for example, for reasons of internal control), but then do not declare them all.

For carrying out these actions, a selection is made of companies having in principle a low VAT sales/VAT purchases relation according to their line of business, or simply by chance.

These companies are subjected to a control of two months of two different fiscal periods, in order to verify that the sales figure and VAT sales declared agree with the supporting documentation. In cases where there are significant differences, the scope of action is expanded, and other periods and other elements are controlled. That is, a full range examination action is undertaken.

Other operations carried out have been the following:

- ⇨ Control of fiscal credit; namely; that VAT PURCHASES declared by the taxpayer is correct.

  Several problems were detected in these controls, such as:

  - non-agreement between VAT purchases deducted in the sworn return and the documentation
  - duplicated slips or accounted for through incorrect amounts or on dates that did not correspond
  - unnecessary acquisitions to obtain and preserve income
  - slips of non-existing companies
  - suppliers who do not pay taxes or pay lower amounts than they should
  - slips that do not comply with the formalities provided in the legal and regulatory standards (for example, expired slips)

- ⇨ Control of fairs and temporary stands
- ⇨ Show presence in specific tourist zones
- ⇨ "Fixed point" Operations for specific lines of business
- ⇨ Detection of unregistered taxpayers (in coordination with other organizations)
- ⇨ Survey among end consumers requesting that they show the documentation supporting the purchase of the good or service upon leaving the establishment.
- ⇨ Verification of the existence of documents on goods on stock and ensuring that they are in order.

6. CONCLUSIONS

The execution of massive examination operations and in particular those intended to control formal obligations (basically the control of invoicing) are of special importance when structuring an examination strategy or plan.

Particularly in Uruguay (where VAT exceeds 50% of tax revenues), and small and medium enterprises exceed 90% of taxpayers, the fiscal presence must consider massive plans. It is a question of achieving an adequate balance between this type of actions of partial scope and actions of total scope or field audits.

These massive control operations have the following characteristics:

- ✓ they are a basically *preventive* tool that seeks to mark presence among the taxpayers by generating in them a greater perception of risk of being discovered on eventual evasion actions, thus indirectly increasing collection;
- ✓ they seek to optimize the *cost-benefit ratio* since even though a significant number of staff is required for these tasks, in most cases there is no need for much technical preparation and the hours devoted by each taxpayer are few, thus rendering more efficient the examination function;
- ✓ technological evolution in handling large volumes of information by the Administration obtained by itself or through third parties improves the scheduling of operations, by selecting and directing those controls to taxpayers from whom there is less expectation of voluntary compliance;
- ✓ the adequate *scheduling and execution* of these operations will allow for rendering the control effective and achieving the objectives sought, since, otherwise, negative results could be achieved and even an effect contrary to the desired one;
- ✓ they are an adequate instrument for selecting companies for field audits, based on evidence found in the visit whereby one may presume the existence of tax deviations.

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Case study:

TOPIC 2.3

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

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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 [1)] such information as the legislation requires to be reported to the Central Customs and Tax Administration, and [2)] 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.

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Case study:

TOPIC 2.3

INFORMATION SYSTEMS FOR SUPPORTING EXAMINATION

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Internal Revenue Service
(United States of America)

CONTENTS: Processing.- Data Analysis.- Compliance Risk / Resource Allocation.- Workload Selection.- Tracking Business Results.- Tools for Examiners.

The ability for the tax administration to provide systems and resources to measure and improve compliance with tax laws is reliant on information systems, which can capture data in the processing of tax returns, analyze data for decision-making, and generate reports, which capture the effectiveness and efficiency of our examination processes. At the Internal Revenue Service of the United States of America, we recently completed the restructuring and modernization of our organizational structure into four operating divisions: Wage and Investment, Small Business/Self Employed, Large and Midsize Business, and Tax Exempt and Government Entity Division. We are also undergoing the modernization of our business systems technology to support those operations. While the taxpayer base for each operating division is different, with different drivers of compliant behavior and different needs, the basic concepts of information systems and the use of such systems is the same. Several aspects of information systems support of the examination processes will be discussed:

Processing
Data Analysis
Compliance Risk / Resource Allocation
Workload Selection
Tracking Business Results
Tools for Examiners

PROCESSING:

Upon processing of the tax returns, data is captured which provide multiple functions. Information is captured and used for several purposes.

Entity information to include the taxpayer's name, address, and identification number is required. Information regarding the return prepare is also gathered. For corporations, we require the consolidated return and related return information, as an example for foreign controlled corporation or foreign owned corporations doing business in the United States. Profit and loss information is required for all entities, and balance sheets for business returns, as well as a schedule to reconcile the book income and expenses to the tax return, and a schedule showing the distribution of retained earnings on a corporate return. The amount of the tax liability with offsets as well as payments made is captured to reflect the balance due or refund owed the taxpayer and the timeliness of the payments and filing.

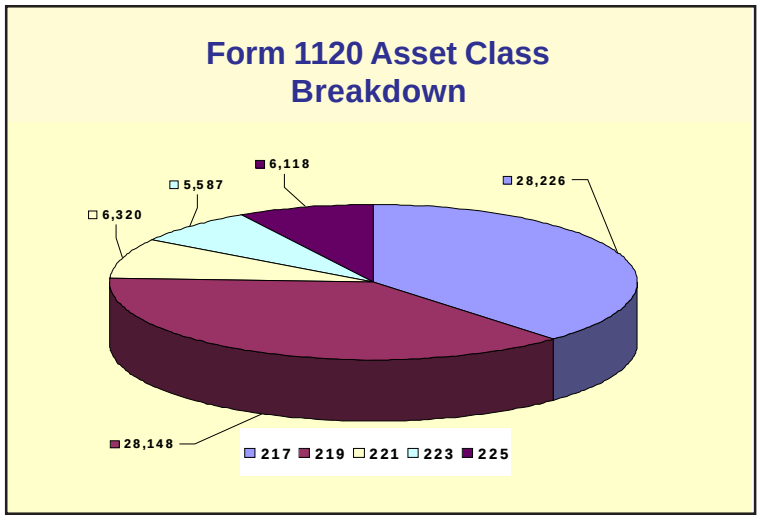
DATA ANALYSIS:

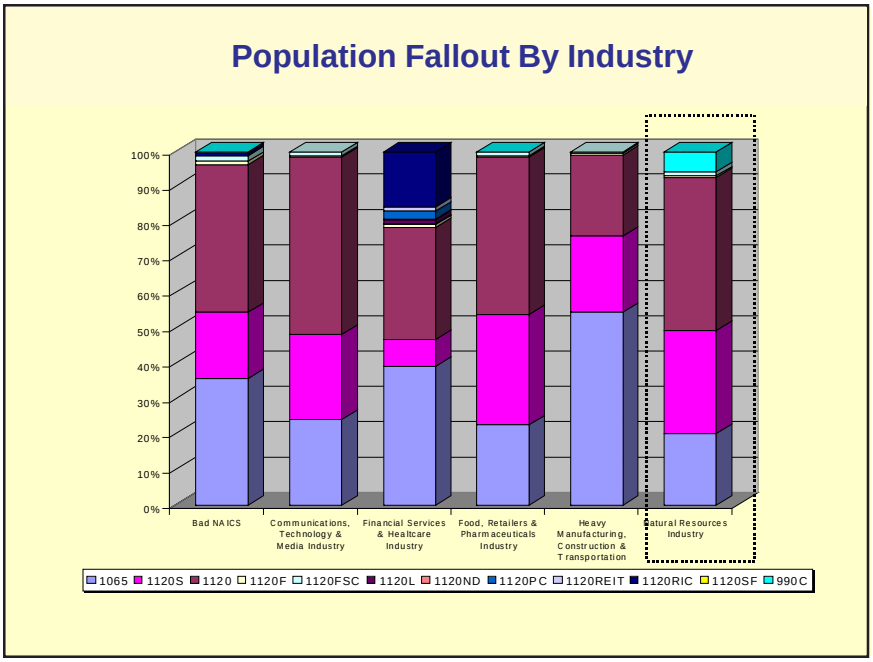
In addition to this information, each tax return is placed into a database identifying the type of return (for example: individual, partnership, corporation, estate and gift), the breakdown within each of those categories based on income or balance sheet information, and type of business or industry (for example: construction, retail, financial services, medical).

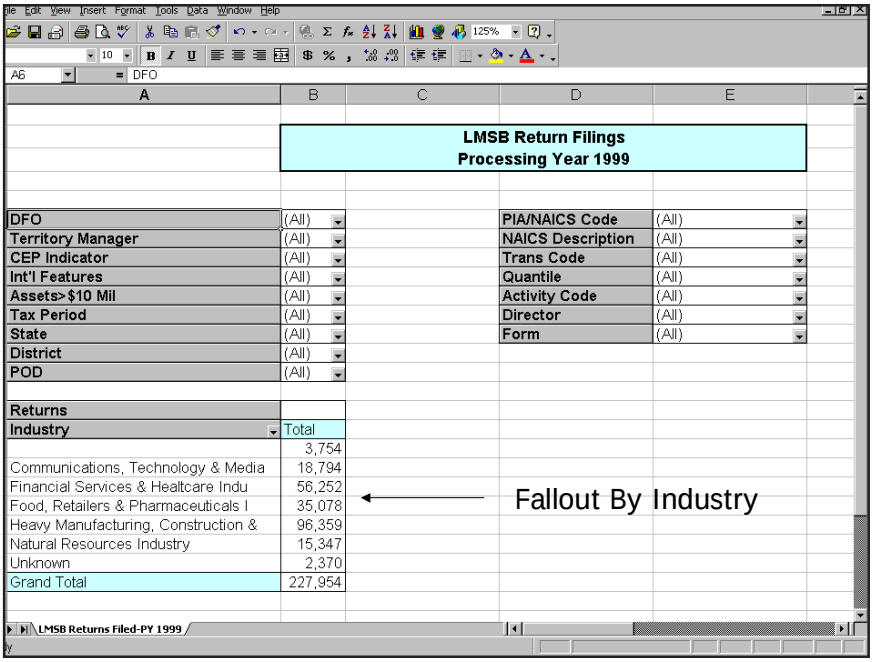
We know general information, regarding the number of taxpayers in each operating division and the average tax liability per taxpayer:

	# of Taxpayers	Avg. Tax.
Wage and Investment	116 million	$ 2,928
Small Business/ Self Employed	40 million	$17,119
Tax Exempt and Government Entities	1.9 million	$36,842
Large and Midsize Business	225,000	$2,073,300

Using the Large and Mid-Size Business Division as an example, there are 225,000 taxpayers in the division. They are partnerships and corporations with assets of five million dollars and over. We know that there are approximately 93,000 partnerships, 75,000 C Corporation returns, and 46,000 Sub-chapter S Corporations. We also know, however, the geographic location of the headquarters operation, and asset and income level, and the type of primary business. That information is important as we make resource allocation decisions regarding the number of examiners in a particular location and the technical skills and knowledge required by that workforce





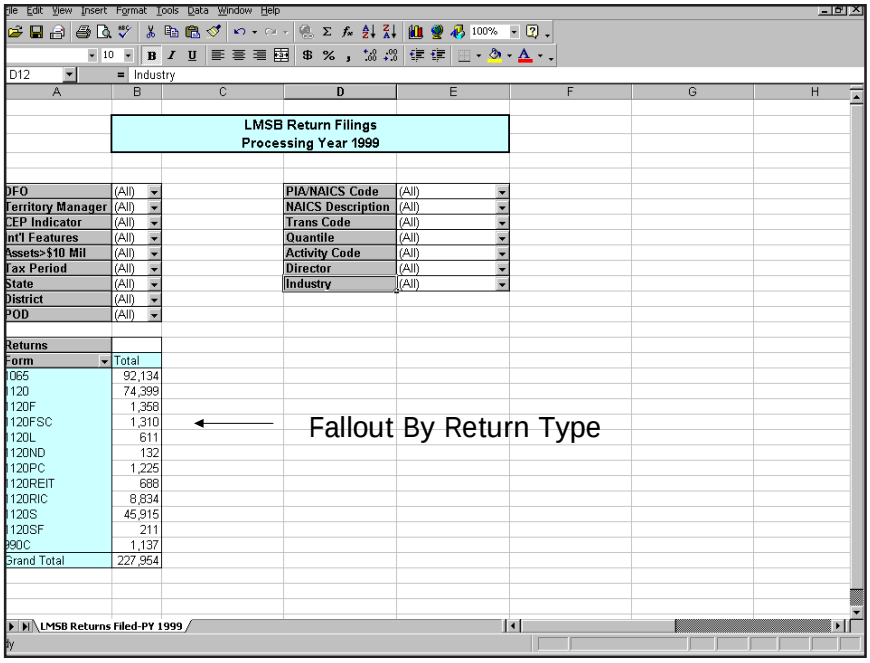


LMSB Return Filings
Processing Year 1999

DFO	(All)	PIA/NAICS Code	(All)
Territory Manager	(All)	NAICS Description	(All)
CEP Indicator	(All)	Trans Code	(All)
Int'l Features	(All)	Quantile	(All)
Assets>$10 Mil	(All)	Activity Code	(All)
Tax Period	(All)	Director	(All)
State	(All)	Form	(All)
District	(All)		
POD	(All)		

Returns	
Industry	Total
	3,754
Communications, Technology & Media	18,794
Financial Services & Healtcare Indu	56,252
Food, Retailers & Pharmaceuticals I	35,078
Heavy Manufacturing, Construction &	96,359
Natural Resources Industry	15,347
Unknown	2,370
Grand Total	227,954

← Fallout By Industry

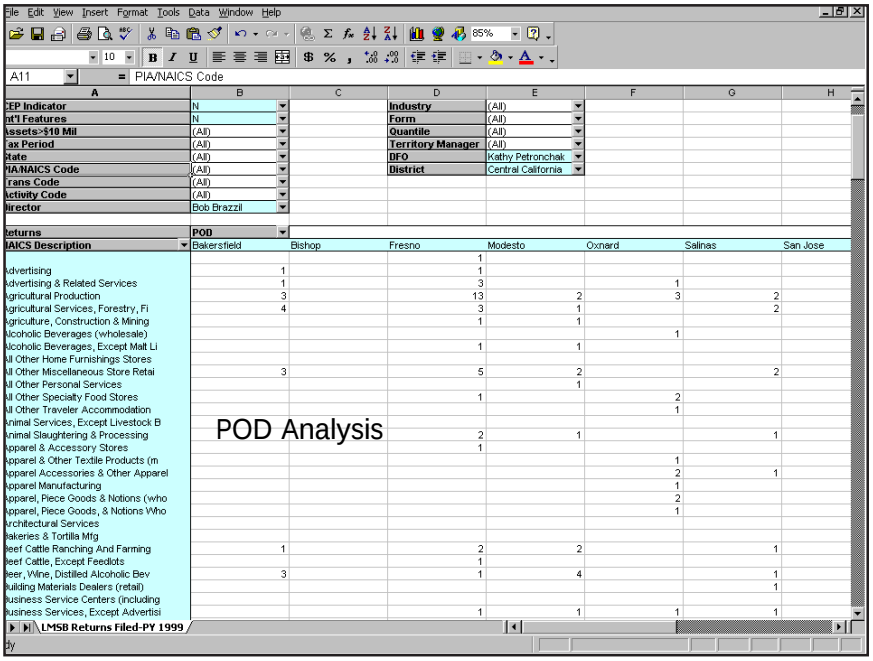


LMSB Return Filings
Processing Year 1999

DFO	(All)	PIA/NAICS Code	(All)
Territory Manager	(All)	NAICS Description	(All)
CEP Indicator	(All)	Trans Code	(All)
Int'l Features	(All)	Quantile	(All)
Assets>$10 Mil	(All)	Activity Code	(All)
Tax Period	(All)	Director	(All)
State	(All)	Industry	(All)
District	(All)		
POD	(All)		

Returns	
Form	Total
1065	92,134
1120	74,399
1120F	1,358
1120FSC	1,310
1120L	611
1120ND	132
1120PC	1,225
1120REIT	688
1120RIC	8,834
1120S	45,915
1120SF	211
990C	1,137
Grand Total	227,954

Fallout By Return Type



CEP Indicator	N		Industry	(All)			
Int'l Features	N		Form	(All)			
Assets>$10 Mil	(All)		Quantile	(All)			
Tax Period	(All)		Territory Manager	(All)			
State	(All)		DFO	Kathy Petronchak			
PIA/NAICS Code	(All)		District	Central California			
Trans Code	(All)						
Activity Code	(All)						
Director	Bob Brazzil						

Returns	POD					
NAICS Description	Bakersfield	Bishop	Fresno	Modesto	Oxnard	Salinas	San Jose
Advertising			1				
Advertising & Related Services	1		1				
Agricultural Production	1		3		1		
Agricultural Services, Forestry, Fi	3		13	2	3	2	
Agriculture, Construction & Mining	4		3	1		2	
Alcoholic Beverages (wholesale)			1	1			
Alcoholic Beverages, Except Malt Li					1		
All Other Home Furnishings Stores			1	1			
All Other Miscellaneous Store Retai	3		5	2		2	
All Other Personal Services				1			
All Other Specialty Food Stores			1		2		
All Other Traveler Accommodation					1		
Animal Services, Except Livestock B							
Animal Slaughtering & Processing			2	1		1	
Apparel & Accessory Stores			1				
Apparel & Other Textile Products (m					1		
Apparel Accessories & Other Apparel					2	1	
Apparel Manufacturing					1		
Apparel, Piece Goods & Notions (who					2		
Apparel, Piece Goods, & Notions Who					1		
Architectural Services							
Bakeries & Tortilla Mfg							
Beef Cattle Ranching And Farming	1		2	2		1	
Beef Cattle, Except Feedlots			1				
Beer, Wine, Distilled Alcoholic Bev	3		1	4		1	
Building Materials Dealers (retail)						1	
Business Service Centers (including							
Business Services, Except Advertisi			1	1	1	1	

POD Analysis

COMPLIANCE RISK / RESOURCE ALLOCATION:

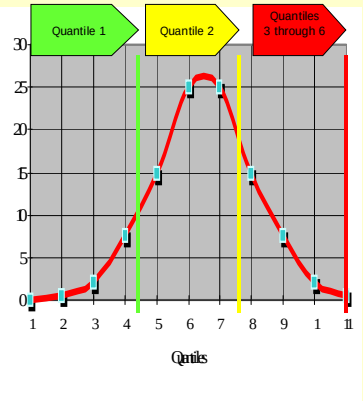
We need to know the compliance risk for all of our taxpayers in three key areas:

Filing Compliance
Payment Compliance
Reporting Compliance

While the compliance risk for filing and payment is higher with the smaller business taxpayers, we must still have a way to assess and deal with noncompliance in all sectors. Reporting compliance is the area of emphasis for the Large and Midsize Business Division. Each return is run through several filters in an attempt to measure the risk of the taxpayer filing an inaccurate tax return. There are several factors that come into play ranging from the complexity of the tax laws and the presence or absence of guidance to the fraudulent intent of the taxpayer in the most abusive noncompliance. We are challenged by our ability to measure the compliance levels and the tax gap created by noncompliance. However, as tax administrations, we have the responsibility to use our resources efficiently and effectively, in a way that instills public confidence in the integrity of our systems. Therefore, it is essential that we apply our resources in the examination processes based on compliance risks and approved projects and studies. We base our screening processes on return information and examination results and data.

Following is an example of how information systems provide the tool for our compliance workload and resource allocation model in the Large and Midsize Business Division. We have approximately 5,500 field examiners and 225,000 taxpayers in offices throughout the country. The returns filed are stratified by return type, industry assignment, amount of assets, geographic location, and score of compliance risk. We believe that the presence of our enforcement efforts has an impact of compliance and have chosen to examine a range of taxpayers in all geographic locations and types of returns. Therefore, after identifying the non-discretionary work (such as abusive compliance projects, research studies and large refund returns) the discretionary work is selected to provide a minimum level of coverage. Once the inventory has been identified, staffing and skill level of the examiners are determined based on that inventory.

DAS/DiF Scoring & Quantile Distribution



DIF Scored Returns

- 1120 Activity Code 217
- 1120S Activity Code 289
- 1065 all Activity Codes

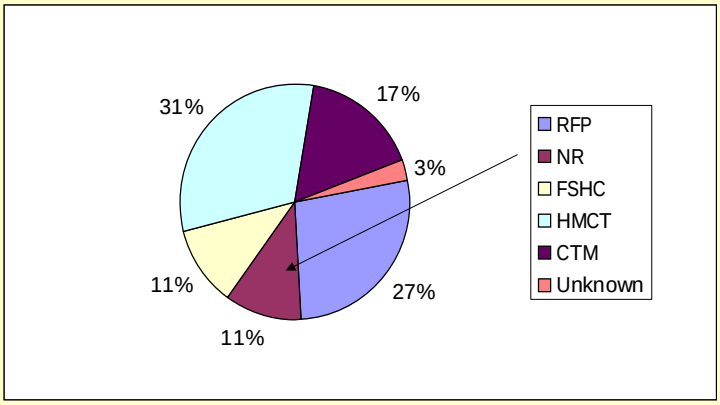
DAS Scored Returns

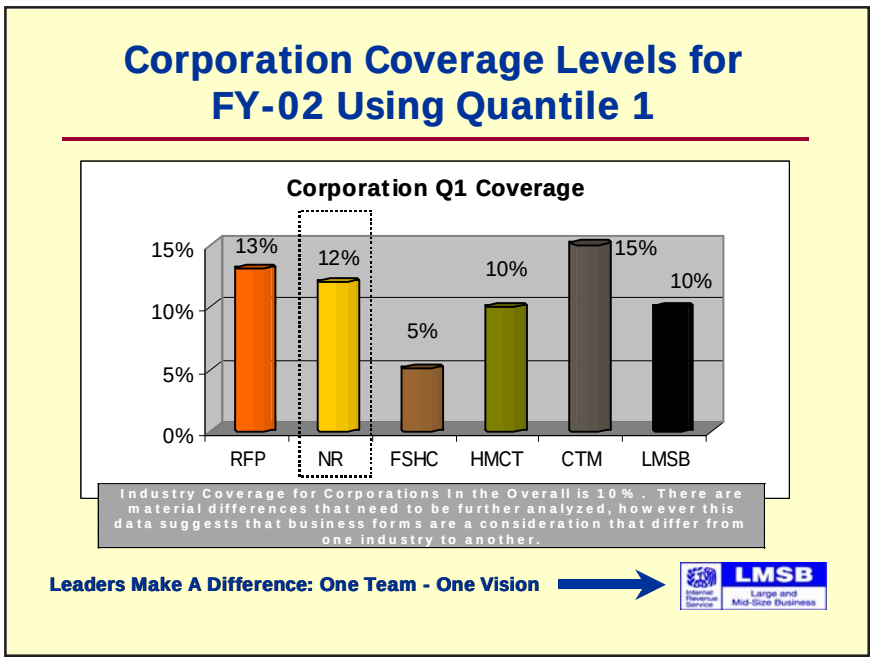
- 1120 Activity Code 219-225
- 1120S Activity Code 290

Quantile Distribution

- Quantile 1 is segments 1 through 4 which is top 10%
- Quantile 2 is segments 5 through 7 which is top 11% - 25%
- Quantile 3 is segment 8 which is bottom 13%
- Quantile 4 is segment 9 which is bottom 3%
- Quantile 5 is segment 10 which is bottom .5%
- Quantile 6 is segment 11 which is 0%

Quantile 1 Cases Across Industries





WORKLOAD SELECTION:

In order to maintain the integrity of our return selection process, we have the systemic scoring and selection processes followed by a manual classification with strict adherence to predetermined guidelines, subject to internal controls and post process review. The case inventory ordering and workload delivery processes are centralized in order to provide the necessary controls.

TRACKING BUSINESS RESULTS:

Examination results are captured for individual cases and compiled into organizational results. For returns examined, it is essential that the results of the examination and the resources applied and time span to achieve the results be measured. The issues of controversy and the resolution of the issues are captured for several purposes.

Organizational results are compiled to determine the efficiency of the process and the business results. Broad organizational measures in terms of returns examined and results as well as the

currency of the process and the time span are measures. The quality of examinations as well as the number of examinations completed are tracked as well. Measures of customer satisfaction and employee satisfaction are a part of the balanced measures of performance that have recently been implemented.

WORKFORCE TOOL:

We are currently developing a tool for our examiners that will serve as a comprehensive resource center, integrated into a multiple systems. Functionality of the center includes electronic research, communications (with taxpayers as well as with other examiners and technical specialists), report writing, tax computations, and remote access to the Internet.

Information from the use of these tools will be tracked to identify trends in issues raised and resolved for purposes of determining training and coaching needs, emerging issues, classification feedback, and the need for additional technical guidance.

In summary, the use of technology and information systems is essential to our ability as tax administrators to enforce the tax laws of our countries and provide for service to each taxpayer and service to all taxpayers.

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TOPIC 3

RESOURCES AND INSTRUMENTS FOR PLANNING AND CARRYING OUT EXAMINATION

Lecture:

TOPIC 3.

RESOURCES AND INSTRUMENTS FOR PLANNING AND CARRYING OUT EXAMINATION

William Baker
Assistant Commissioner
Canada Customs and Revenue Agency
(Canada)

CONTENTS: I. Introduction.- II. Compliance Strategy.- III. Compliance Programs.- IV. Resources & Tools.- V. Legal Powers – Obligations and Responsibilities.- VI. Respect for Taxpayers – Rights and Liberties. - VII. Audits.- VIII. Investigations Programs.- IX. Looking Ahead.

I. INTRODUCTION

The mission of the Canada Customs and Revenue Agency (CCRA) is to promote compliance with Canada's tax, trade, and border legislation and regulations through education, quality service, and responsible enforcement, thereby contributing to the economic and social well being of Canadians.

CCRA deals with thousands of Canadians each day. **Four enduring values** guide the way in which we interact with our clients, our colleagues at CCRA, and other stakeholders and partners, such as other governments and private sector associations.

- **Integrity** is the cornerstone of our administration, ensuring that we treat people and apply the law fairly. Integrity requires that we act with honesty and openness.

- **Professionalism** is the key to success in achieving our mission, reflecting an ongoing commitment to the highest standards of achievement. Professionalism requires that we act with dedication and skill.
- **Respect** is the basis for our dealings with colleagues and clients, being sensitive and responsive to the rights of individuals. Respect requires that we act with courtesy and consideration at all times.
- **Co-operation** is the foundation for meeting the challenges of the future and building partnerships aimed at realizing common goals.

The vast majority of Canadians are honest and pay their fair share to maintain essential government programs. Today, about 95 per cent of revenues collected come in voluntarily without CCRA taking any direct enforcement action. Some 95 per cent of Canadians 18 years of age and older file a tax return, up from about 85 per cent ten years ago. Taxpayers determine what they owe and pay it voluntarily. This is called self-assessment and it's a system based on trust. When that trust is violated, honest taxpayers expect the CCRA to take action to enforce Canada's tax laws. In any country, honest taxpayers expect their tax administration to ensure the integrity of the system.

This expectation is clear from the intense public pressure on CCRA to plug any leaks in the system. For governments in Canada and in other countries, tax evasion means greater difficulty in controlling public debt or cuts to programs or delays in reducing taxes for all taxpayers. For businesses, the result is unfair competition. And for individuals, their confidence in the system — the underpinning of the self-assessment system — is eroded.

The CCRA recently conducted a comprehensive survey to gauge public opinion about tax compliance and administration. Almost three thousand Canadians were surveyed by telephone using a private sector research company.

The results of this survey indicated generally positive impressions of our Agency. For example, 85 percent were in agreement that we conducted ourselves professionally, 77 percent were in agreement that we acted honestly and 74 percent were in agreement that we acted fairly.

On the more disturbing side, respondents believed that, on average, 29 percent of Canadians engage in tax fraud. Furthermore, 31 percent of Canadians believe evasion is increasing compared to 9 percent who believe it is decreasing.

Thankfully, there is still quite a bit of confidence in the integrity of the system. Two-thirds of Canadians believe it is highly or quite likely that evaders will be caught. Two-thirds of Canadians also agree that audits and penalties should be increased to combat fraud.

Revolutionary changes, from the rise of the information economy to the aging of the baby boom generation, pose a daily challenge to the tax system. Companies have had to adapt rapidly to the threats and opportunities posed by technology, free trade and globalization. And individual Canadians have had to show innovation and adaptability in a new economy where jobs may no longer be for life.

Ensuring compliance in this environment is an ongoing challenge. It requires credible enforcement strategies that are seen to protect honest taxpayers by making sure those who cheat are caught. But it also requires public education, community outreach and a strong client focus. It means making voluntary compliance as easy as possible for all taxpayers — businesses and individuals alike. And it means staying ahead of change — being able to predict new trends and adapting compliance strategies to meet them, often working in partnership with groups who share similar objectives.

If one word can be used to describe the self-assessment system it is “democratic”. Our system is based on citizen responsibility; taxpayers figure out their taxes owing and remit the amount. If they are owed a refund, or are entitled to an income tested benefit program, their claims are assessed and processed quickly — usually a matter of days — because of the assumption that returns are filed honestly and correctly.

But for the system to work, a high level of voluntary compliance is necessary. In the absence of that, the system would quickly become burdensome and intrusive, losing the attributes that currently make it so efficient. Under this system, the overriding challenge for the government becomes fostering a culture of compliance.

Public education, facilitation and credible enforcement represent both the underpinning and the strategy toward a culture of compliance.

- **Public Education**

  For individuals and companies alike, voluntary compliance begins with the understanding of their entitlements and responsibilities under our country's tax laws. For CCRA, this means providing «user friendly» guides, information brochures, inquiry services, tax clinics and individualized help to assist in the preparation of tax and other returns. It also means identifying particular areas of non-compliance, the root cause of that non-compliance, and ensuring that education is used where applicable, to help resolve these problems.

  The CCRA reaches 100,000 high school students every year with a course entitled: *Teaching Taxes*. This is significant for three reasons: one, it helps young people to fully appreciate their rights and responsibilities as citizens at an early age; two, it helps young Canadians understand the significance of filing and tax planning; and three, it teaches young people that a range of benefit programs are delivered through the tax system and that they must file a return to ensure that they receive them. CCRA also works with new immigrants to help them understand and comply with Canada's tax laws. More than 100 tax clinics are held each year. These clinics explain the law and address participant's questions on compliance issues.

  Working with business associations and advisory committees, the CCRA provides information, offers a technical inquiry service and provides special sessions on topics of particular concern. CCRA has recently strengthened these outreach programs. For example, an extensive program of community visits has been started for small and medium size businesses. These visits combine service, education and compliance checks. They have identified compliance issues such as improper books and records, many of which are resolved through improved understanding of the rules and requirements.

  Another type of outreach activity is our Scientific Research and Experimental Development (SR&ED) public information

seminars. These seminars provide business communities useful information on the definition of SR&ED, the evaluation criteria, eligible activities and expenditures, how to apply, and documentation requirements to support a SR&ED claim. Our objective is to enable businesses to receive their full entitlements to tax credits under this important incentive program.

- **Facilitation**

  Making it easier to self-assess and file voluntarily is a key objective of the CCRA, as is encouraging individuals and businesses — who for whatever reason had not been filing — to enter the system and begin complying voluntarily. This means providing quality service to individuals and businesses and reducing the administrative load for all businesses.

  CCRA works in close partnership with industry and labour associations to address problem areas, both from the CCRA's and association's perspective, as well as on strategies for streamlining processes. It has established more than 30 advisory committees, including ones for seniors, large business and small business, collections, international issues, and electronic commerce, to name a few.

- **Credible Enforcement**

  Credible enforcement acts not only to deter tax evasion but also serves to remind taxpayers that CCRA is working to maintain the fairness of the tax system by ensuring that all pay their fair share.

  The CCRA carries out various verification and enforcement activities regarding all taxes administered including commodity taxes and income tax . For individual returns, these activities range from the identification of non-filers and GST non-registrants, to initial assessment of returns by matching information and assessing risk, to post assessment reviews of higher risk files, to periodic reviews of deductions and credits, to special projects. They also include audits of the self-employed and unincorporated businesses and investigative and other measures to fight tax evasion.

For business returns, and given the large dollar amounts and complex transactions involved, good risk management means that all tax returns of Canada's largest corporations are audited. The coverage rate for other businesses will vary, depending on their size, complexity and risk assessment.

II. COMPLIANCE STRATEGY

The successful achievement of the CCRA's mission to promote compliance depends to a significant degree on effective processes for identifying, prioritizing, and addressing compliance risks.

Risk Management and Risk Assessment

Risk management and assessment are essential for the efficient allocation of finite resources among competing audit programs and initiatives, and for placing the organization in a favourable position to respond to new opportunities.

Risk management is a process whereby an organization attempts to minimize losses and maximize its opportunities to achieve success in attaining its corporate goals. The cornerstone of the risk management process involves the identification, measurement, and analysis of risks. This process is known as risk assessment.

Risk assessment is used to guide audit programs by: providing estimates of the size, likelihood, and consequences of specific risks; identifying compliance patterns and trends within industry, geographic, or other demographic breakdowns; modeling and profiling identified non-compliance issues at the individual account level, or for specific non-compliance issues; and ultimately targeting high risk files.

Data Matching

CCRA has a comprehensive information base with more than thirty existing operational systems that contain relevant data for risk management and assessment. The business number assigned to all corporations provides a key link to this data. Name matching

algorithms are also used to link non-CCRA data. Shareholder links are established using payroll information. Some of the systems involved in enhancing our compliance strategy are as follows:

- The Computer Assisted Audit Selection system is used to identify high-risk files for potential audit activity. It provides auditors with detailed taxpayer information relevant to specific actions and provides information to analyze compliance trends and evaluate the impact of compliance strategies. The Audit Report Generator Online system also improves targeting of audit activity by enabling local offices to have direct access to this data in order to select high-risk files for audit.
- Non-filers and non-registrants (NF/NR) are identified through the use of a system which selects NF/NR taxpayers who did not file or are not registered, and automatically issues a request to file or register.

In addition to internal operating systems, CCRA's comprehensive databases include information from:

- General sources such as Dun & Bradstreet and the Bank of Canada; and
- Specific sources such as Provincial data on Property Assessments and Vehicle registrations, and data on neighbourhood incomes, boat registries and third party information slips.

Additional Indicators of Risk

In addition to computer assisted risk assessment and data matching, the following activities are also important in identifying files at risk:

- *Leads from other audits*

Information from other files, audits, investigations, or outside sources may lead to the selection of a particular file for audit. For example, while auditing the purchase expenses of a business, the auditor may want to ensure that those purchases are being reported as income by the supplier.

- *Informant leads*

There are approximately 20,000 leads generated by informants, all of which are reviewed. Those with audit potential are selected for audit.

- *Special audit projects*

Frequently, the compliance of a particular group of taxpayers or industry is sampled. If the results indicate that there is significant non-compliance within the group, its members may come under audit on a project basis, at a local, regional or national level.

- *Local knowledge*

Auditors in the individual offices across the country have a good sense of the local economy, business practices, and where to look to find non-compliant taxpayers. This could involve an industry particular to the local area, a specific taxpayer based on something written in a local newspaper or magazine, or just by observing how certain merchants run their businesses. For example, a coffee shop may not be ringing up the sales on the cash register.

The CCRA also benefits from being an integrated organization responsible for tax and customs programs. For example, we are working on coordinated tax and customs audits, which will allow us to ensure consistency between valuation and transfer pricing.

III. COMPLIANCE PROGRAMS

CCRA's compliance programs play a central role in protecting the integrity of the tax system. These programs must understand compliance, identify areas of non-compliance and develop and implement appropriate responses. Compliance programs range from research, to risk management and assessment, to verification of returns, to audit and to criminal investigations. In all cases, these programs adopt a balanced approach to verification and enforcement activities, which includes client assistance and service aimed at ensuring compliance. More specifically, compliance programs include examinations, audits and investigations aimed at ensuring compliance with income tax, GST and customs laws; verification and enforcement activities at the international level,

including the administration of international tax agreements; and the administration of various tax incentive programs such as the scientific research and experimental development program, the film or video production services tax credit and the flow through shares program, through the validation and provision of tax credits to qualifying businesses.

Compliance programs aim to identify the most serious cases of non-compliance, take appropriate corrective measures, and generally deter non-compliance. They also seek to reinforce compliant behaviour through risk assessment, service and education.

Verification Methods

A wide variety of verification methods are used by the CCRA, in addition to the traditional full scope audit, as outlined below:

- *Restricted Audits*

These are limited scope audits, which focus on a specific issue or issues that have been identified as having high risk for non-compliance.

- *Compliance Reviews*

A compliance review is a set of audit procedures designed to detect non-compliance in one tax while auditing the other taxes (e.g. a compliance review of Income Tax may be conducted during a full scope audit of GST). A compliance review involves an examination of specific risk indicators to determine if there are any issues requiring further audit action.

- *Combined Audits*

A combined audit is when one auditor audits two taxes (e.g. Income Tax and GST). The aim of this program is to increase revenue coverage levels and to be less intrusive to the taxpayer.

- *Core Audits*

These are audits of files selected at random, using statistical sampling techniques and without any reference to risk scoring. The results of Core Audits are used to measure compliance levels in specific segments of the population and to refine risk assessment models.

- *Industry Audit Approach*

Most local offices across Canada have organized their auditors into industry-specific audit teams. This allows for the development of sector expertise and the appropriate audit practices and procedures to address compliance issues unique to specific industries.

- *Examination Programs*

The mandate of these programs is to maintain and enhance voluntary compliance among taxpayers who derive their income from salary, rental, sales, investment, small business, farming, and fishing and to review Taxpayer Requested Adjustments before they are allowed.

- *Pre-payment Review / Verification*

Credit returns and rebate applications are subjected to system edit verification and may be referred for review or audit prior to payment.

IV. RESOURCES & TOOLS

A. Staff

Of its total complement of over 40,000 staff, the CCRA's compliance programs employ almost 10,000 auditors, accountants, forensic accountants, lawyers, economists, statisticians, computer specialists, real estate appraisers, business valuators and other professionals, the majority of whom are located in 42 field offices across Canada. Ensuring that the staff has the necessary knowledge, skills, resources, technology and a positive work environment is critical to protect an increasingly complex tax system and to contribute to a competitive business environment.

Qualitative factors

In recognition of the Audit staff's key role, CCRA is committed to creating an environment, which allows professional development and opportunities for employees.

Taxpayers and their representatives have become very sophisticated in arranging their financial affairs. The increased use of technology to effect financial transactions has minimized the impact of national borders. It is important that staff receive appropriate training to respond to these new challenges.

The CCRA is committed to team building and to having its employees view themselves as team players. Audit staff may start their career with the CCRA as a generalist with sufficient knowledge and skills to carry out general audit work. As their career progresses, skills are developed to conduct more complex audit work in one business line, industry sector, or in a specialized work area.

Audit Qualifications

The CCRA minimum educational requirements for an entry level auditor are:

- possession of a secondary school diploma; and,
- successful completion of introductory and intermediate accounting as determined by one of the three recognized accounting associations in Canada.

Over 60% of our auditors have professional accounting designations or university degrees.

Audit Training

Training is very important to our organization and is considered essential in increasing the auditors' efficiency and effectiveness. Depending on the career path chosen, technical and technological training will be given to broaden knowledge and skill sets, specialization will be encouraged, or management skills enhanced. Training profiles, which are linked to employee competency profiles (CCRA competencies include knowledge, skills, abilities, values, attitudes and behaviours), have been developed for audit positions. The training profiles assist managers in identifying which courses

or other learning events should be considered for employees in each position. On average, 10% of an auditor's time is spent on training.

Investing in training not only yields better auditors, it also yields more satisfied auditors. Auditors have many career opportunities and could easily increase their income by moving to the private sector. Training is an investment in people and our staff regard it as a positive feature of the CCRA - a feature that can help attract, retain and motivate staff.

B. Other Resources

Laptop computer

CCRA auditors have, for several years now, been using laptop computers with specialized software to assist them in performing their audits. The laptops store the following information or programs:

- technical information or policies contained in court cases, interpretation bulletins, information circulars, operating manuals, and internal memoranda. This information enables the auditor to research an issue without having to leave the taxpayer's place of business or carry all of these documents in paper format.

- templates for letters, working papers and standard forms often used by auditors. These templates reduce the number of hard copy forms the auditor used to carry, reduce the need for clerical assistance in typing letters, and in general, reduce time consuming and repetitive steps.

- applications that make calculations for the auditor (e.g. shareholder loan, capital cost allowance and the automobile benefit). Once the auditor enters certain key amounts, the computer makes calculations pursuant to the legislation, thus reducing errors and audit time.

- upload/download functionality. A download is intended to accomplish three major tasks: first, reduce the necessity of

an auditor having to return to the local office to obtain additional audit work; second, provide the auditor with a detailed picture of the Client's activity with the CCRA in an electronic format, and third, provide a database of client data that can be automatically utilized to reduce repetitious audit work and minimize audit documentation errors. An upload is used primarily to allow an auditor to communicate audit results directly back to CCRA mainframe systems without the necessity of coming to the local office. In addition an upload reduces data transposition errors.

Computer audit specialist

As many businesses are now keeping their records electronically (e.g. in-house or store bought software, mainframe or stand alone computers) auditors often require assistance to access and manipulate taxpayer records.

The computer audit specialist (CAS) assists auditors by planning and conducting an on site examination of taxpayers' computerized records and books of account, including an analysis of the flow of data through the system. This identifies the appropriate accounts for audit, and the most efficient method of extracting the data.

The CAS also designs and uses computer programs to obtain and analyze information from the taxpayers computerized system. The CAS verifies the completeness and accuracy of the reports generated from the taxpayers computerized records and books of account. The specialist also extracts, prepares and transfers data to the auditors' laptop computers.

Large Business Audits – Audit Protocol

The Audit Protocol for Large Businesses was introduced to increase co-operation, openness, and flexibility in the audit process. It is not a legal document but a framework that establishes guidelines for the audit process and relationship. It was produced in consultation with internal and external stakeholders.

The Audit Protocol is a multi-year arrangement containing audit plans and mechanisms for the resolution of issues. The protocol covers the Agency's major audit functions including Income Tax, Goods and Services Tax, international tax, tax avoidance, scientific research and experimental development, and payroll deductions. In time, customs-related verification work may be included as well. Interest by large businesses is high – already about one quarter of large businesses have signed protocols.

Industry specialist

An industry specialist is a person with extensive expertise and knowledge of a particular industry sector from an overall business point of view, and an in-depth knowledge of the accounting and tax issues of that industry. The industry specialist role is to use that expertise to act as a single point of contact between the industry and the CCRA, identify points of friction or audit risk that impact on that industry, and develop strategies and solutions to resolve them. Industry specialists regularly meet with associations representing businesses in their industry, CCRA staff who deal with that industry, and other federal and provincial bodies such as the Department of Finance. These meetings are an important source of information and problem identification. The specialist also reviews and updates the reference material available to auditors, to ensure significant audit risks and established assessing positions are explained.

When an issue is identified that has broad impact across an industry, the specialist will take the lead in arriving at a solution, and communicating it to internal and external clients. Specialists also maintain extensive data about their industry for reference purposes. Senior auditors working on files in that industry can contact the specialist for detailed information and advice about their file.

V. LEGAL POWERS – OBLIGATIONS AND RESPONSIBILITIES

Auditor's rights & authorities

The *Income Tax Act and Excise Tax Act (GST)* legislative provisions authorize auditors to:

- Inspect, audit, or examine taxpayer's books and records;
- Examine property;
- Enter premises;
- Request "reasonable assistance"/receive answers to "proper questions";
- Copy documents;
- Enter a "dwelling house" with the consent of a judge; and
- Issue a requirement for any information or document.

In addition to the above auditor rights & authorities, investigators, with the authorization of a judge, under the *Criminal Code* are authorized to:

- Enter and search any building, receptacle or place;
- Seize things noted in a search warrant; and
- Seize things not specified in a search warrant.

Taxpayer Compliance is the Audit Objective

The predominant goal of the CCRA is taxpayer compliance. The primary audit objective of our auditors is to assess the correct amount of a taxpayer's tax, interest and (if any) penalties. The auditors' objective can only be met effectively and efficiently when taxpayers comply with their obligation to (i) keep books and records, (ii) file returns, (iii) allow, and assist in, the inspection, audit or examination of the books and records, and (iv) attend and answer proper questions. Auditors are in the best position to resolve all significant non-compliance issues and thus achieve taxpayer compliance.

Financial civil penalties

Tax legislation contains various measures to encourage compliance, including penalties for taxpayers that provide false or misleading information relating to tax matters. Examples of where penalties may be applied include:

- Failure to Keep Records and Books of Account;
- Failure to File Returns;
- Failure to Attend with Auditor and Answer Questions;

- Failure to Give All Reasonable Assistance to Auditor for Access to Records;
- Failure to Provide Information or Documents; and
- False Statements or Omissions (*where gross negligence is found*).

On June 29, 2000, Canada enacted third party civil penalties. Prior to this, there were no civil penalty provisions that applied to those (such as accountants, lawyers, promoters, etc) who counsel others to file their returns based on false or misleading information.

The objective of the third-party civil penalties is to deter third parties from making false statements or omissions in relation to income tax or GST matters. These penalties are directed at ensuring tax compliance and deterring inappropriate behaviour.

The third party civil penalties move away from the term ***"gross negligence"*** to a defined term ***"culpable conduct"*** to ensure that the penalties only apply to the worst cases, where there is a very high degree of misconduct. They would not apply to instances of ordinary negligence or innocent oversight.

There are two third party penalties for misrepresentations of tax matters by third parties. The first, referred to as the "planner penalty", is directed primarily at those who prepare (or participate in), sell or promote tax shelters or tax-shelter like arrangements. Such plans often involve the over-valuation of property or excessive or inflated costs. The second penalty, referred to as the "preparer's penalty", is directed at those who provide tax-related services to particular taxpayers, such as preparers who turn a blind eye to any false statements in their clients' returns or who counsel them to file tax information that is false.

In addition to penalties, interest calculated at a prescribed rate is also applied to any balance due for the period that the amount is outstanding.

The introduction of third party penalties in Canada has been very controversial as private sector professionals expressed concern about the improper use of these penalties by the CCRA. We are

actively working with the professional community to define application guidelines and are committed to providing them with periodic reports on the use of the penalty.

In Canada, as in any country, it is essential that the tax administration and private sector tax professionals have an open and constructive relationship as, only by working together with a shared accountability, can we achieve the best service and maximize compliance.

Non-financial sanctions / penalties

The CCRA distinguishes between tax avoidance, where transactions create unintended advantages by circumventing the law or its intent, and tax evasion, where a taxpayer knowingly reports tax that is less than the tax payable. Tax legislation includes specific anti-avoidance sections and a general anti-avoidance rule that allows the CCRA to challenge transactions that are contrary to the spirit and intent of the law. The CCRA also works closely with the Department of Finance to implement legislative changes to address avoidance issues.

Tax evasion occurs where a taxpayer knowingly reports tax that is less than the tax payable. This is accomplished by making, participating in, assenting to, or acquiescing in the making of false statements or deceptive statements in any return; altering, secreting, or disposing of books or records, or making false entries or omissions in books of account, or conspiring to do any of these acts; or in any other manner attempts to evade payment of tax. These actions are illegal and can be prosecuted as such.

Taxpayers are encouraged to come forward of their own volition to correct deficiencies in their past reporting or dealings with the CCRA. It is the policy of CCRA that any person who has failed to file a return or who has filed incorrect returns and subsequently makes a voluntary disclosure that is substantially complete, will be permitted to settle any liability of tax with statutory interest and late filing penalties. The CCRA will not prosecute such persons or seek to impose civil penalties for gross negligence or willful evasion. Recently, the CCRA transferred responsibility for the Voluntary Disclosure Program from the Investigations area to the Appeals

area. We have witnessed a considerable increase in the number and value of disclosures as it would appear that taxpayers are more comfortable dealing with appeals officers.

In addition to administrative penalties for evasion, the government can file criminal charges leading to a fine of 50% to 200% of the tax sought to be evaded and imprisonment for up to 5 years.

An offence is also created for making false statements or altering documents for the purpose of obtaining or increasing a tax refund or credit. Such willful contravention, on summary conviction, will attract a fine of not less than 50 percent and not more than twice the refund or credit sought and imprisonment for a term not exceeding 2 years.

A charge for an offence involving willful contravention for the purpose of evading tax payable or obtaining an increased tax refund/credit may be prosecuted by indictment, in which case an accused may be liable to a larger fine or a longer term of imprisonment. If convicted, an accused will be liable to a fine of not less than 100 percent, and not more than 200 percent, of the tax sought to be evaded or refund / credit sought to be obtained, and to imprisonment for a term of up to 5 years.

In a typical year, the CCRA successfully prosecutes over 200 tax evaders resulting in extensive fines and several prison terms. Prosecutions are publicized as they serve as an excellent deterrent and reinforce honest behaviour.

VI. RESPECT FOR TAXPAYERS – RIGHTS AND LIBERTIES

The CCRA and its staff take into consideration the *Charter of Rights and Freedom,* the *Privacy Act*, and the *Access to Information Act* in carrying out their duties.

The *Canadian Charter of Rights and Freedoms* governs how legislative objectives may be achieved, rather than the matters that may be dealt with. The Charter imposes limits on government activity in relation to fundamental rights and liberties.

From a tax administration perspective, actions taken by CCRA must conform with the Charter. Generally speaking actions taken during the course of an audit are said to be regulatory in nature and do not attract the rights under the Charter. As a matter develops into an investigation there are some differences in case law as to when and how the rights of an individual under the Charter come into play. Clearly, search warrants and prosecutions must comply with the Charter, as must most actions taken by Investigations staff. The key issue facing CCRA at the moment with respect to prosecutions is exactly how and when the Charter applies to the transfer of a file from audit to Investigations, that results in a prosecution.

The *Privacy Act* gives Canadian citizens and people present in Canada the right to have access to information that is held about them by the federal government. The Act also protects against unauthorized disclosure of personal information. In addition, it strictly controls how the government will collect, use, store, disclose and dispose of any personal information.

The Act is designed to protect the confidentiality of information provided to the Government by individuals. Personal information under the control of the federal government cannot be disclosed without the consent of the individual except in accordance with the Act. Individuals can request under this Act to see what information the Government has about that individual.

The *Access to Information Act* gives Canadian citizens as well as people and corporations present in Canada the right to have access to information in federal government records that are not of a personal nature. There are certain exemptions for such things as information about national security, law enforcement and trade secrets.

The CCRA, to reinforce the enduring values of integrity, professionalism, respect and co-operation, has developed a new declaration and guide on client rights, entitled “Your Rights”, which informs clients of their rights to:

- privacy and confidentiality of personal information;
- fair treatment;

- courtesy and consideration;
- bilingual service and designated offices;
- complete, accurate and clear information;
- every entitlement allowed under the law; and
- formal review.

Constitutional protection, legislative provisions and public declarations of citizen rights are important ingredients in encouraging compliance as they provide assurances to taxpayers that the tax administration will conduct itself in a legal, proper and respectful manner.

VII. AUDITS

An audit is an examination of a taxpayer's financial matters and records of accounts to ensure the accuracy of the taxpayer's reported tax and other related liabilities. An audit may cover one or more reporting periods and may cover more than one tax.

For our purposes, we consider a quality audit to be a well-documented and supported body of work completed after a careful, timely review of appropriate financial and other relevant information in keeping with the objective and scope of the audit. The conduct of a quality audit includes ongoing dialogue with the taxpayer/auditee and accurate, timely responses to requests for information.

Quality means to consistently do the right thing, in the right way, with the right result over an extended period of time. It means consistent, accurate and equitable application of the tax legislation administered by the CCRA. For audit programs, it means achieving a high standard of excellence in performance, results and interactions with auditees, practitioners and the general public.

Planning

Planning is an essential component to developing and completing an audit in an orderly way. Before the start of the audit, auditors familiarize themselves with any background material relevant to the taxpayer and the taxpayer's industry. An audit strategy and a general audit plan is prepared, which normally includes the following:

- the timing and scope of the audit;
- a communication strategy covering matters like how often an auditor should submit queries during an audit, the type of queries that should be made in writing, and the acceptable target dates for receiving responses to such queries.

Operating manuals assist auditors to audit certain financial statements and different types of businesses (e.g. restaurants, taxi, auto dealers etc.). Other operating manuals provide technical application assistance in applying the law (e.g. shareholder appropriations, penalties, unpaid amounts, etc.). These manuals are referenced to get an understanding of the industry and the type of books and records that may be encountered during the audit.

Contact with the taxpayer

Throughout an audit, CCRA auditors are committed to ensuring that:

- the emphasis is on cooperation and not confrontation;
- the process is transparent and open; and
- the audit findings are communicated and thoroughly discussed with the taxpayer throughout the process.

The auditor contacts the taxpayer to arrange a convenient date to start the audit and to inform the taxpayer of the information required on the day the audit begins. The auditor reviews the taxpayer's file, plans the audit and prepares a list of queries. Pre-packaged query sheets are available as interview questionnaires and audit plans to ensure that all relevant questions are asked and all relevant accounts are audited.

The auditor may tour the taxpayer's premises to gain a better understanding of the transactions recorded (or not recorded) in the books.

In keeping with our mission to promote quality service, we have initiated the distribution of an "Audit Pamphlet" and an "Audit Client Service Evaluation Questionnaire". The purpose of the pamphlet is to improve compliance through taxpayer education. To that end,

the pamphlet is designed to provide self-employed taxpayers and lower-income-range corporations with an overview of the audit process as well as an explanation of their rights and obligations with respect to an audit. The questionnaire survey will assess the impact of the pamphlet, as well as our clients' views regarding CCRA's performance in the area of small and medium business audits.

Examination of the books and records

Fieldwork should progress in a co-operative and courteous manner. To expedite the audit and reduce any unnecessary burden on taxpayers, auditors:

- concentrate on significant issues;
- discuss significant queries with the team leader before raising them with taxpayers;
- keep taxpayers informed about the progress of the audit, their findings and any potential adjustments; and
- recommend the issue of requirements under the Income Tax and Excise Tax Acts for taxpayers to provide information for the administration of taxes, after repeated requests for information and documentation have failed. If the taxpayer is a corporation, requirements are served on one of its authorized signing officers.

Taxpayers are asked to provide their comments on any findings and any potential adjustments as the audit proceeds. In this way, the auditors can resolve as many issues as possible during the audit.

Communicating the results of the audit

When the auditors complete their fieldwork, they either provide the taxpayer with a letter stating that, for the years reviewed, there are no adjustments, or they give the taxpayer a proposal letter.

The proposal letter sets out:

- issues of non-compliance including the relevant facts, and the CCRA's position and rationale; and
- issues that have been agreed to by the taxpayer.

Auditors ensure that taxpayers receive copies of all requested documents (or paraphrased information from such documents) and working papers supporting proposed adjustments. However, certain source documents and working papers, such as third-party leads, confidential sources, and privileged information, cannot be disclosed because they are protected by law.

The proposal letter invites taxpayers to submit, within a reasonable period of time (typically 30 days), any comments that might help the auditors arrive at a well-founded conclusion to the audit. Auditors consider the taxpayer's submissions and respond by addressing the points raised.

Upon completion of the audit, the taxpayer is provided with our final position in writing, which includes the following:

- a list of final adjustments, with an explanation for each adjustment;
- the terms of any agreed settlements;
- any revised tax schedules;
- any outstanding issues (e.g., referral to Tax Avoidance); and
- the taxpayer's right to an independent and objective formal review.

Use of indirect methods to verify income

There are various audit tests that can be utilized to determine potential income change. In the absence of an audit trail or adequate records and source documents, indirect methods of verification are used to determine tax potential and to serve as a basis for assessing.

The following are some examples of methods that are used by auditors during their audits:

- net worth;
- bank deposit; and
- projections.

These methods can identify tax problems within a file, and these particular methods are accepted by the courts.

Net Worth:

The net worth method is only adopted in cases where books and records are either non-existent, substantially incomplete, totally inaccurate or where there are indications that income has not been reported even though records appear accurate.

The use of the net worth method to measure income is based on the premise that a taxpayer's income for a period is the increase in the taxpayer's net worth during that period. Personal expenses must be added to the taxpayer's net worth to determine income.

A taxpayer's net worth is the excess of his total assets (business and personal) over his total liabilities (business and personal) at a specific date plus any personal expenditures incurred during the year, such as food and lodging.

Bank Deposit:

This indirect method of verification involves reconciling bank account deposits with reported sales. This method can be summarized as taking the total deposits per bank statements and deducting the non-revenue deposits.

Any bank deposit that cannot be traced to a specific source is considered an unidentified bank deposit. These deposits may be in the taxpayer's business bank accounts, especially where the taxpayer does not have a double entry accounting system, or in the personal bank accounts of the taxpayer or the taxpayer's spouse.

In any analysis of unidentified bank deposits, the auditor's objective is to determine whether the deposits resulted from suppressed income. Where direct audit testing fails to identify the source of the bank deposits, the auditor will interview the taxpayer to obtain further information.

Projections:

The projection method is based on the extrapolation of relevant information obtained from the taxpayer's records, in order to arrive at a reasonable basis for assessment purposes. The projection

technique is adapted to, and custom designed for, the taxpayer's specific business and books and records.

For example, in the case of a pizza outlet, and from the purchase invoices, we could determine the number of boxes used during the year (after adjusting for the opening and ending inventory), and multiply this number by the average selling price of the pizza to obtain a reasonable basis for determining projected sales.

Referrals to Investigations where tax fraud is suspected

Sometimes auditors encounter evidence of fraud and refer it to Investigations. The criminal investigation program complements the CCRA's other enforcement programs in promoting voluntary compliance and self-assessment. This program fulfils these objectives by investigating, penalizing and recommending prosecution of significant cases of fraud under the Income Tax Act, the Excise Tax Act, and the Excise Act. The compliance strategy includes publicizing court convictions as a means of encouraging voluntary compliance with the Acts we administer.

Process for resolving differences

Despite the best efforts of both taxpayers and auditors to resolve issues, differences may arise that need special attention. Taxpayers should try to resolve issues with the auditor and the team leader. If there are any issues that cannot be resolved, either party can refer the matter to senior officials who will try to resolve the issues in a timely manner.

On occasion, auditors may require technical assistance on issues arising from the audit. The audit sections in the field offices have technical advisers who provide this assistance. When the technical sections in the field office require assistance, they may refer their query to either our Policy and Legislative Branch concerning interpretative issues or to our Technical Applications Sections in the CCRA for application issues.

Opportunities for redress

Appeals - Disagreements can arise on how the law is interpreted or applied. In such cases, taxpayers can file an objection within 90 days of the mailing of the *Notice of Assessment* by writing to their local tax services office. Taxpayers are given an independent and objective review of their notices of objection by appeals officers who reconsider the assessment. If the taxpayer is not satisfied with the decision rendered by the appeals officer, an appeal may be lodged in the courts.

Fairness Legislation - Fairness provisions allow the CCRA to apply reasonable discretion in order to rectify certain problems caused by prescribed circumstances beyond a taxpayer's control. The legislation allows for the cancellation or waiving of interest and/or penalties under certain circumstances, and the acceptance of certain late filed or amended elections.

VIII. INVESTIGATIONS PROGRAMS

The Investigations Program's overall mandate is to enhance compliance levels with the various Acts administered through effective enforcement and, thereby, contribute to the public trust, fairness and integrity of the self-assessment system. This mandate is addressed by way of the following four programs:

Criminal Investigations Program (CIP)

The CIP objectives are to strategically investigate, assess, penalize, seize and recommend prosecution of significant cases of fraud.

The objectives include publicizing court convictions as a means of encouraging specific and voluntary compliance with the acts administered. The publicity policy ensures that information is provided to the media on a local, regional and/or national basis. Publicity is a means of obtaining the maximum deterrent effect from our successful prosecutions. Investigations is one of only a few programs that openly publicize the specific impact of non-compliance on persons, as regular assessments and civil penalties are protected by confidentiality.

As part of the case selection process, local offices endeavour to accept referrals that will provide as wide a geographical and industry coverage as possible within a local office. This objective can only be achieved over a span of years considering the territory covered by each local office, the annual number of completed prosecutions, and the mix of referrals received from various areas of the local office.

Special Enforcement Program (SEP)

The overall objectives of this program are to:

- Minimize the accumulation of unreported illicit wealth amassed by persons engaged in illegal activities, thereby causing disruption to organized crime, stem the infiltration of legitimate business by criminal elements, and reduce the activities of organized crime on society; and

- Forge strategic alliances and partnerships with law enforcement agencies with the view to improve CCRA efficiency and expand the impact of our actions on organized criminal activities, including areas outside direct taxation, such as proceeds of crime and the proposed money laundering legislation.

The main motivation of criminal organizations is the attainment of profits. Governments of most countries have realized that to combat organized crime, ways have to be found to control the wealth generated by their activities. The enforcement of the laws administered by the CCRA is one effective way to control such wealth.

Illegal activities of organized crime are usually viewed as pertaining to violent predatory crimes such as drug trafficking, robberies and prostitution. However organized crime is also extensively involved in other types of non-violent crime such as stock fraud, investment fraud, international telemarketing fraud, money laundering, corruption of public officials, and income tax, GST and Customs fraud. The program targets all those illegal activities that generate profits.

The SEP program complements the Proceeds of Crime legislation enacted by the Government in attacking criminally obtained wealth. Some of the advantages of the SEP program are that it is not necessary to separate legitimate from illegitimate income, and the burden of proof is less stringent within the context of a revenue civil reassessment than with criminal proceedings under the Proceeds of Crime legislation. SEP continues to play an important role in the government actions against persons involved in organized criminal activities.

Leads and Assistance Program (LAP)

The LAP program objectives are summarized as follows:

1. To control and screen leads received from informants relating to alleged non-compliance under the revenue acts administered, refer these leads to the appropriate area for action, and report on their disposition.
   These leads are reviewed, databases are searched for information and a decision based on potential tax at risk, as well as other criteria, is made as to the action to be taken. Leads are recorded in a database and those leads forwarded to other areas for action are followed up for results. These activities are handled by Investigations because of their expertise in such matters and the need to protect the information and the identity of informants.

2. To control and process, on a priority basis, international requests for assistance in gathering evidence for criminal investigations, including grand jury and multi-agency investigations.

3. To assist other functions and business lines, as required, with administrative prosecutions and requirements for information. The assistance provided includes advice and guidance to Audit, Collections and International Tax in the handling of requirements, handling of Criminal Code access orders, and processing requests for information from other government departments including Human Resource Development.

Anti-Evasion Program

The objectives of the anti-evasion program are:

- to discover and analyze potential sectors containing tax evasion and the evasion of duties within the illegal and quasi illegal economies;

- to maximize CCRA resources through the creation and enhancement of partnerships which address the illegal and quasi illegal economies;

- to increase the CCRA's understanding of the «illegal» economy from a taxes at risk perspective so that effective responses can be developed and implemented;

- to discover, create and assist in the implementation of strategies to address tax evasion and the evasion of duties with a cross program/ cross CCRA view; and

- to ensure that senior management is aware and current of both macro level evasion problems and anti-evasion initiatives.

IX. LOOKING AHEAD

The CCRA operates in a complex environment characterised by rapid change. The pressures for change come from both within Canada, and from our participation in the global economy. Issues such as Canada's demographic structure, globalisation and electronic commerce will affect how the CCRA achieves compliance in the future. In order to maintain high levels of compliance, the CCRA needs to maintain and improve its ability to identify emerging trends. We need to constantly adapt our compliance strategies, as well as the way we do business.

In Canada, the greatest challenge is presented by the changing demographic profile of the Canadian population. Canadians are ageing. We are living longer, and having fewer children. These demographic trends will have a significant impact on the economy,

as well as the government spending. While the Department of Finance is concerned with the policy implications for the nation's economy and social institutions, the CCRA's main challenges arises from the corresponding changes to income sources, and the intense competition for specialised skills.

The changing demographic profile means, amongst other things, that more and more Canadians earn income from sources other than working for an employer, for example, pensions, investment income, and self-employment income. This means that more and more of Canadians' income are not subject to withholding of taxes at source. This represents a major challenge to the self-assessment system. With this trend, the CCRA is focusing increased attention on various ways to ensure accurate, full reporting of income for tax purposes.

Another major trend impacting on Canada and the CCRA is the globalisation of economic activity. Canada is a trading nation. Increasing trade and the establishment of new trading patterns affect how the CCRA accomplishes its mission. The CCRA must increase its efforts to protect the integrity of Canada's tax base while minimising the compliance burden imposed on businesses. Similarly, the CCRA devotes considerable effort to addressing tax havens, international tax avoidance schemes, transfer pricing issues and the proper disclosure of income from foreign sources, which are all areas of increased attention and focus.

In a similar vein, as globalisation continues there is increasing pressure for international harmonisation in government policies, programs, standards and regulations. Governments must intensify their co-operation and provide international frameworks for the effective management of global issues, including taxation and customs administration. The CCRA is improving its understanding of these developments together with other OECD countries, international organisations, the private sector, and with the provinces.

The continued growth of information technology presents both an opportunity and a challenge. As a means for the CCRA to accomplish its compliance mission, the opportunities offered by the Internet are virtually unparalleled. The CCRA needs to constantly invest in technology and in its employees, looking to find innovative ways to

improve service to clients. The potential of the Internet in delivering information and assistance on tax and customs issues to Canadians promises to revolutionise how the CCRA fulfils its compliance mission. Electronic commerce also presents a significant challenge, particularly in the context of globalisation. E-commerce is evolving quickly and raises many new compliance issues for tax administrations. These include, for example, difficulties in identifying the location of supply or even where a business is located, complexity in tracking funds and verifying compliance. The CCRA will have to evolve along with the growing implementation of e-commerce around the world in order to fulfil its mandate.

Achieving compliance, voluntarily or otherwise, is the primary challenge of all tax administrations in CIAT and the rest of the world. The environment is complex and dynamic and we must all, by working independently and together, be innovative, adaptive and persistent in ensuring our examination programs yield the optimal results. Our respective treasuries rely on the revenue for social and economic programs. More importantly, our citizens rely on the integrity of the tax system to improve voluntary compliance and overall public confidence in the professionalism and commitment of their tax administration.

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Case study:

TOPIC 3.1

LEGAL POWERS OF THE TAX ADMINISTRATION

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CONTENTS: Introduction.- 1. Characterization of the Function of Examination.- 2. New Challenges for the Examination Function.- 3. The Legal Powers of the Tax Administration for the Exercise of the Examination Function.- Conclusions.

INTRODUCTION

Based on a modern conception of the tax administration it can be said that, in general, its mission consists of effectively promoting compliance with tax obligations, with efficiency, in a framework of equity and integrity. The purpose of this is to contribute to social welfare.

This consists of such diverse elements as: the effective promotion of compliance with tax obligations as goal; efficiency as a way of acting; observance of equity and integrity as governing principles and the concern to contribute to the welfare of the community as ultimate goal.

The objective of effectively promoting compliance with tax obligations, means achieving that such compliance is examined and also that, normally, it takes places spontaneously. In order for that spontaneity to be generalized, it is necessary that the tax

administration encourage taxpayers to comply by carrying out two types of actions: facilitation of that compliance with all the means it has and, at the same time, the effective fight against noncompliance.

Regarding the way in which it must carry out its objective, the administration should act with efficiency in a twofold direction: applying a criterion of rationality by imposing and demanding formal obligations so as to not generate an unjustified indirect tax burden for taxpayers, and developing their own functions at the least possible cost so long as this does not commit its efficiency.

The governing principles for action of the tax administration would be the principle of equity, which involves affording a fair treatment to taxpayers, respecting their rights and, consequently, a total lack of arbitrary actions in their decisions, and the principle of integrity, which refers in particular to the observance of an ethical conduct from officials of that administration.

Finally, the ultimate goal of all actions of the tax administration would be to contribute to the welfare of society. The internalization of this among officials will allow them to understand their role of service, overcoming a narrow vision of “mere collector of taxes.” This, together with an equitable and honest action in the aforementioned terms, will facilitate the projection of an image toward society that furthers a greater acceptance of taxes.

The realization of all those elements that may be identified in the mission of the tax administration: objective, way of acting, principles and goal, will depend in the first place on a political decision establishing a general strategy with that orientation. However, it will also depend on equipping the very administration with the necessary resources. These resources basically consist of sufficient motivated and trained personnel at all levels, availability of appropriate financial and technological means and, additionally, a normative table granting the administration the indispensable powers to fulfill its task.

Given that the activity carried out by the tax administration is primarily a regulated activity, where a small room for discretion is allowed, the legal powers that are granted to it are basic in the attainment of its objectives. This is particularly related to the exercise of the control functions of compliance with tax obligations.

Thus, for example, it will be very difficult to effectively exercise that control for a tax administration that has important limitations to gain access to information on events of tax importance, attributable to a taxpayer and/or a third party related to him.

Consequently, the legal powers the tax administration has, conditions in an important manner its possibilities of complying with its mission and, particularly, with the strategic objective of effectively promoting compliance with tax obligations through actions of fighting noncompliance with those obligations.

This paper, starting with a quick characterization of the function of examination and its principal elements, highlights the powers and limitations to the exercise of this function by the tax administration, which in a direct or implicit manner, are established in the Tax Code Model of CIAT.

1. CHARACTERIZATION OF THE FUNCTION OF EXAMINATION

a. The functions of the tax administration

Without taking into consideration the organizational structure and competencies of the tax administration of any country in particular, it can be considered that the functions of this type of administration are those necessary for the implementation of tax norms to the realization of tax credit. In other words, the functions to be carried out by the tax administration would be those geared toward identifying and registering taxpayers, learning from voluntary return of taxpayers or from the conduct of its control activities of the events generating taxes, assessing or controlling the correction of tax self-assessment and accessory obligations, taking steps to collect voluntary tax payment or through legal means and developing every other activity that is necessary till tax obligations are cancelled, thereby generating revenues for the State Treasury.

The nature and degree of complexity of administration actions, going from the inception of the tax obligation to its cancellation, may vary notably as a result of the taxes administered, the way in which they are being assessed (self-assessment, administrative or mixed assessment), the definition of taxpayers and their behavior (voluntary or forced compliance), etc. However, as it is traditionally recognized, it is possible to integrate all those actions into three

large groups that would constitute the basic or essential functions of the tax administration, such as: the function of tax collection, the function of tax examination and the function of recovery.

In a very summarized manner, it can be said that:

- The function of collection would cover all types of activities that are particularly related to voluntary compliance, such as taxpayer assistance and information, registration at the taxpayers' registry, the receipt of tax returns and payments, the updating of the current tax account, as well as massive processing for the control and filing of tax returns and payments and the issuance of requirements in case of noncompliance, validation of filed returns, rectification of arithmetic mistakes;

- The function of examination may be related to the diverse control activities of compliance with taxpayers' obligations dealing with the registration, return, payment, billing and registration, etc. However, of particular importance in this function are the fight against fraud and tax evasion through the identification of fraudulent conduct of noncompliance with tax obligations and the compilation of necessary elements to determine taxes evaded and penalize those responsible;

- The function of recovery would cover all activities that are necessary to ensure and seek the payment of taxes and its accessories through legal means, provided payment is not made in a timely and/or voluntary manner.

b. The objective of the examination function and the compliance gaps

It is difficult to establish an unequivocal concept that defines the contents of the examination function, because it is just a part of a whole represented by the work of the tax administration

In a broader sense, the function of examination could be characterized as the set of control actions of compliance with emerging obligations of tax norms, establishing obligations for taxpayers and third parties. In other words, it involves actions

geared toward detecting noncompliance with those obligations and the contribution of elements that allow the detection of omitted taxes and the application of the corresponding penalties against those responsible.

The set of control actions of compliance with tax obligations could be divided following the commonly used graphic representation, through concentric circles, of gaps in compliance.

A first gap would consist of the failure to register with the tax administration by those who are mandated to do so.

The second gap corresponds to taxpayers who, despite being registered, have not provided information on their tax situation ignoring their obligation to do so, that is, they have not “filed.”

The third gap consists of those taxpayers who despite being registered and having filed taxes have not supplied truthful information.

Finally, the registered taxpayers who have filed their taxes correctly, but who have not paid the assessed taxes comprise a fourth gap.

It can be said that among the previously listed situations constituting noncompliance gaps, the examination function is particularly related to the three first gaps and consists of actions for the detection and correction of noncompliance with the obligation to register and file taxes. It establishes the consistency of the information supplied by taxpayers and in case this information is incorrect or has not been provided, it identifies the elements that allow for the adequate determination of tax obligations and applies the corresponding penalties.

Regarding the function of verification, special attention must be given to the control of truthfulness in filing tax returns. Such actions are related to the detection and correction of the forms of tax evasion of greater importance and difficult to establish by the tax administration. These cases involve situations that present the appearance of compliance with tax obligations and that, however, often times correspond to the most significant violations of these obligations, such as tax fraud practices. In those situations authorities do not even have an indication of the omission of a formal obligation, which may point to the concealment of tax

bases. On the contrary, information is being provided in a formal and timely fashion and the administration must determine whether such information is partial or false and must make the corresponding adjustments.

Examination in this case involves the analysis of the consistency of the information supplied by the taxpayer. This information requires a careful examination involving the work of audits, whether internal or in the field.

The auditing processes can be carried out in the offices of the tax administration based on all the information available there, whether it comes from audited taxpayer returns or from third parties. In this case, it will consist of verifying that the different blocks of the returns are consistent with returns of other taxes filed by the taxpayer and with information obtained from third parties, through cross checks of information.

The inconsistencies and anomalies identified in an office auditing process may give rise to the administration requesting additional information from the very taxpayer. Should a satisfactory explanation not be provided, authorities may make the corresponding adjustments or launch a field audit at the taxpayer's facilities.

Field audits, due to their investigative nature, are generally subject to strictly regulated procedures (taxpayer rights, inspector powers extension, time limits, etc.). Here authorities seek to investigate the documentation and records that support the information provided in the returns and, should they be inconsistent, establish the tax situation of the audited party.

c. The purpose of the examination function and the establishment of subjective risk

Traditionally, the examination function was considered almost exclusively as a direct means to get additional income. The proposals for examination action, carried out in an intermittent and nonsystematic fashion, centered on this immediate objective, to the tune of variations in tax resource requirements.

Presently, it should be understood that the general objective of the examination function, whether restricted or broad, is geared toward accomplishing greater efficiency in the management of the tax administration as a whole. This means bringing the results achieved in the implementation of the tax system closer optimum results, that is, those under an ideal situation in which taxpayers would fulfill their tax obligations correctly and voluntarily.

As part of that general objective, the predominant purpose of the examination function must be participating in the creation of a risk situation for tax evaders, which may encourage them and other taxpayers to display a better behavior in the future. It must help promote better compliance with tax obligations.

It should be pointed out that the creation of such risk is not exclusively dependent on the function of examination, because the idea is to generate the belief among taxpayers (subjective risk):

- not only that their noncompliance will be detected,

- but also that their will be inevitably forced to comply and given this,

- this would be significantly more onerous than if they had complied voluntarily.

As can be seen, the detection of noncompliance is directly related to the examination function, nonetheless, it constitutes the starting point for the configuration of the risk and this is why it deserves special consideration.

2. NEW CHALLENGES FOR THE EXAMINATION FUNCTION

There is no doubt that the existence of a market of goods and services more competitive and integrated each time, in a world characterized by globalization and digitalization, has a strong impact on tax systems and administrations.

As part of this new scenario are prominent three topics related to the control of taxes that worry tax administrators, such as transfer pricing, electronic commerce and harmful tax competition practices. They also require the consideration of new legal norm provisions

that govern the functions of the tax administration and, especially, the exercise of the examination function.

a. Transfer pricing

As a result of the globalization that will result in a notable increase in international economic transactions, both in their size and in the variety and complexity of the way in which they are conducted, new challenges were created for the effective control of taxation of the benefits of companies. This holds particularly true when dealing with transactions between related companies.

Overbilling, underbilling, billing of fictitious transaction, the use of figures or forms of inadequate transactions (sub-capitalization, for instance), are some of the mechanisms applied to unduly assign income and expenses between related companies, with the purpose of minimizing tax payments. They constitute forms of tax evasion of a fraudulent nature.

In general, when dealing with the factors that have an impact on the displacement of benefits in a covert manner internationally, the existence of marked differences in the levels of taxation is placed in the first place, in particular income taxes. We base ourselves on the assumption that the aim is transferring profits from countries with high taxes to countries with low taxes, so as to reduce the overall tax burden on the income of a group of multinational corporations.

The issue of the control of securities involving international transactions between associated companies has not received the necessary attention in most of the countries of Latin America and the Caribbean. The legislation on this matter is generally scarce, if not nonexistent, and tax administrations themselves do not have, for the most part, an organization that will allow them to check transfer pricing in an effective manner.

At the level of tax legislation, few countries in Latin America and the Caribbean have norms establishing the principle to be observed for the fixation of international transfer pricing between associated companies. Much less, do they have methods to be applied by tax administrations to adjust these prices, when different from values viewed as “normal.”

Most of the income tax laws, and in some cases the tax Code, establish general provisions that authorize the tax administration to challenge the values attributed by taxpayers to transactions, when they are not in keeping with market prices. However, these provisions are in most cases insufficient and inaccurate regarding the statute of limitation of the principle and the methods enabling the administration to make the adjustment, when necessary. This will enable taxpayers to know the requirements they must observe so that the values assigned to their intra-group transactions can represent admissible prices.

The control of transfer pricing, in particular of multinational corporations, is a problem that is part of the examination functions of the tax administration at the international level. This involves entering into the most complex and difficult field of tax examination. In the first place, requesting information on persons and events outside of their jurisdiction is worse in the case of Latin America and the Caribbean, because the address and control of multinational groups (parent companies) are normally outside of Latin America and the Caribbean.

b. Electronic commerce

Another worrying issue related to tax controls deals with the media developed by modern technology for the conduct of commercial and financial transactions. Today we frequently speak about the existence of an Information Global Infrastructure, where the Internet represents a global matrix of computer networks that are interconnected to communicate with one another.

There is no doubt that the Internet technology is having a profound impact on the world trade of services that includes among others “software,” entertainment products (movies, videos, games, sound recordings), information services (databases, “online” newspapers), technical information, product licenses, financial, professional and technical assistance services. These transactions are completed “online” with a significant reduction of costs.

From the viewpoint of taxation, concerns result from the fact that the Internet has not only eliminated national borders for the conduct of business activities but also the identity of the companies and individuals engaging in such activities.

Theoretically, those who trade “on-line” would be subject to the same tax treatment applied on who do so otherwise. However, this is difficult to apply when dealing with electronic commerce, whether because of the difficulty in identifying the transaction and its players and because determining the tax jurisdiction for such transaction may be difficult. Most of the criteria that are applicable are geared toward resolving conventional situations.

Without a doubt the fast-growing electronic commerce introduces a new problem of significant impact in the tax field. Such problem has to do with both the redefinition of a tax structure and the identification of the tax compliance control means resulting from a transaction.

c. Harmful tax practices

The most common form of international tax evasion is the use of the so-called “tax havens,” viewed as the countries without taxes or with very reduced tax levels. Such countries usually have an extensive and sophisticated bank structure as well as strict rules on confidentiality. This allows for the accumulation of benefits in them or the mobilization of capitals therefrom without being taxed or without tax consequences of importance. Nonetheless, it is necessary to take into account that the concept of “tax haven” is a relative concept. Any country can become a tax haven compared with another country when its taxes are significantly lower or when it does not apply its taxes as the other country does (definition of the narrower taxable income concept, concession of tax incentives, existence of agreements to prevent international double income taxation, etc.).

On the other hand, the existence of “tax havens” and “preferential tax regimes,” established to attract and give shelter to the significant resources from abroad, entail undesirable forms of tax competition. They promote tax evasion in other countries and in many instances protect profits derived from illicit activities.

This is a growing concern in our days, which has prompted important efforts, geared toward neutralizing the effects of what has come to be known as “harmful tax competition.”

In 1998 the OECD published a report that has to do with harmful tax practices, under the form of tax havens and preferential tax regimes. This report focuses on the analysis of activities of high geographical mobility, such as financial and services, defining the criteria to identify these harmful tax practices and makes recommendations to face them. Among these recommendations, those related to the tax administration should be pointed out, to include:

- That the countries that do not have rules regarding the supply of information on international transactions and foreign operations of resident taxpayers, consider the adoption of said rules and that countries exchange information obtained in accordance with those rules.
- In the context of countering harmful tax competition, countries must review their laws, regulations and practices that govern access to bank information, with the purpose of eliminating access impediments to such information by tax authorities.
- That the countries must undertake programs to intensify the exchange of significant information on transactions in tax havens and preferential tax regimes that constitutes harmful tax competition.
- That the countries consider undertaking coordinated programs for the application of tax provisions (such as simultaneous examinations, specific projects of information exchange or joint training activities) relative to the income or taxpayers who benefit from practices that constitute harmful tax competition.

3. THE LEGAL POWERS OF THE TAX ADMINISTRATION FOR THE EXERCISE OF THE EXAMINATION FUNCTION

In order for the Administration to effectively develop each of its functions, it is necessary that it have the corresponding legal powers, that is, that the juridical framework where it operates provides for sufficient powers. Such powers must be established in a precise manner and, at the same time, must not affect the rights and guarantees of taxpayers, keeping a balanced position in the treasury-taxpayer relations.

Regarding the function of examination, the existence of those powers entails a special importance, given the nature of its activities. As was previously characterized, that function consists of a set of actions for compliance control both dealing with the examination of obligation omission and/or the truthfulness of the information supplied by taxpayers and those responsible. It also includes gathering of necessary information and data for the administration to assess the omitted taxes and its accessories and for the application or penalties where appropriate.

The powers recognized in the CIAT Tax Code Model to the administration for exercising its examination functions are broad, especially if related to the obligations established for taxpayers, those responsible and third parties, relative to the facilitation of examination and the provision of information.

These powers deal with the actions of the tax administration to corroborate that taxpayer or third responsible parties have complied with the tax provisions and, if so, assess the omitted taxes, investigate tax offenses, impose the corresponding penalties, and provide information to the Tax Administration from other countries. They are established mainly in Titles II and III of the CIAT Tax Code Model, which deals with the obligations and rights of taxpayers and third parties, and the powers and obligations of the tax administration, as well as in other provisions of the Code Model.

There is a very intimate interrelationship between the norms included in the aforementioned Model Titles. It can be construed that in many cases the first are the corollary to the second and vice versa. However, we decided to consider explicitly the rights and obligations of the taxpayer as a way of granting more certainty and security to the norms of this kind, which govern the treasury-taxpayer relationship, both for the administration and those administered. This results in the establishment of a situation of real balance, without consciously incurring in reiterations.

Below we will comment on the provisions of the CIAT Tax Code Model, relative to the powers of the tax administration related to the development of the examination function, dealing with both the powers explicitly established and those resulting from the obligations of taxpayers and third parties. It also deals with the limitations

imposed for the exercise of this function through the obligations levied on the administration, the rights established in favor of taxpayers and third parties and the procedures required for carrying out the examination.

a. Powers

Within the norms included in the CIAT Tax Code Model and that are related to the powers conferred upon the administration regarding the examination, it is possible to differentiate those that establish, on one hand, the powers for the exercise of the examination function and, on the other hand, the rights of taxpayers and third parties for facilitating the exercise of this function.

i. Powers for the exercise of examination

Powers to examine (Art. 67)

In order to determine whether taxpayers or third responsible parties have complied with tax norms and determine the taxes omitted, investigate the tax offenses, impose the corresponding penalties and provide information to the tax Administration of other countries, it is established that the tax Administration will be empowered to:

1) Ask taxpayers, third responsible or third parties to *appear* in its office to answer questions or to recognize signatures, documents or properties.

2) Ask taxpayers, third responsible or third parties to *display* in their domicile, establishments or Administration offices accounting information as well as to provide data, documents or reports that are required, with individual or general scope.

3) *Practice examinations in the domicile* of taxpayers, third responsible or third parties related to them and to *review their accounting records and properties.*

4) Practice or otherwise order the *assessment or physical examination of every kind of property, even during its transportation.*

5) *Collect from officials and public employees* of all levels of the State political organization the *reports and data they may have as a result of their functions.*

6) *Intervene the* inspected *documents and take security measures for their conservation.*

The tax Administration may *request the assistance of the public force* to exercise these powers, and it may *conduct raids and sequester properties and documents* should it be necessary.

Place for the exercise of examination (Art. 68)

It is established that the acts of examination may be carried out:

1) In the *tax domicile* of the taxpayer or in that of his representative

2) Where *taxable activities are* either totally or partially *carried out.*

3) *Where there is some evidence of the taxable event.*

Inspectors may *enter the estates or places where activities are carried out* in the conduct of their business, provided that they comply with the *requirements established in the norms which govern the examination procedure.*

Examination (Art. 114)

It is established that the tax Administration may exercise its examination powers through the procedure of *examination of compliance with tax obligations* of taxpayers, *in the establishments open to the public, without the need to meet a formality other than the identification of the acting official.*

Precautionary measures for the conservation of vouchers (Art. 69)

It is determined that for the *conservation of the documentation* and of any other relevant element for determining the tax debt, *precautionary measures (bail, deposit or sequestration)* may be adopted, which will be proportional to the end that is pursued. In no case shall they produce damage, which is difficult or impossible to repair.

Sequestration of accounting records (Art. 70)

It is established that inspectors may *gather accounting records for examination at the tax offices* for a certain period of time, *provided that one of the following assumptions occur:*

1) Whoever at the placed being visited *refuses to allow the examination* or access or refuses to make available the accounting records, correspondence or contents of the securities box, or blocks examination in any other way.

2) There are *accounting systems, records or books that do not meet the legal requirements.*

3) There are *two or more accounting systems* with different content.

4) *Two or more returns have not been filed.*

5) *The seals or official markings* placed by examination officials *are torn, tampered with or destroyed* or the purpose for which they were placed is prevented by any means.

6) *The examined party is facing a strike or suspension of work.*

In case that the inspectors gather the accounting records, they must prepare a document to that effect.

Assessment of the tax obligation (Art. 71)

It is established that the Administration may *proceed to assess, by the government's initiative, the tax obligation on certain or presumed basis, in any of the following situations:*

1) When the taxpayer or third responsible party *failed to present the return;*

2) When the *tax return contains doubts* on its sincerity or accurateness *and it is confirmed it is incorrect;*

3) When the *tax return is not supported* by documents, accounting books or other means established by the norms or that they are not shown.

Forms of assessment (Art. 72)

It is established that the assessment by the administration will be made:

1) On certain basis, taking into consideration the elements that allow for the direct identification of the tax generating events;

2) On *presumed basis, using any of the following media:*

   a) Applying the data and *available background* that are relevant.

   b) Using *elements that indirectly accredit the existence of the properties and the income, as well as revenues, sales, costs and receipts that are normal in the respective economic sector,* given the dimensions of the productive or family units.

   c) Estimating the *signs, indices or modules* that occur for the respective taxpayers, in accordance with the data of background that they have under *similar* or equivalent *assumptions.*

Assessment on presumed basis (Art. 73)

It is established that the tax administration may *assess taxes on the presumed basis, when taxpayers or third responsible parties:*

1) Oppose or somehow *block the development of the examination.*

2) *Do not present accounting books and records, verification documentation or do not provide the reports* pertaining to the compliance with tax norms.

3) *Any of the following irregularities take place:*

   a) *Omission of the record of operations, income or purchases, as well as alteration of cost.*

   b) *Registry of purchases, expenses or services not realized or not received.*

c) *Omission or alteration in the registry of the stock* that must appear in the inventories, or recording that stock at other than cost prices.

d) *Do not comply with the obligations on inventory valuation* or do not keep the control procedure for them, as mandated by tax norms

4) Other *irregularities* were observed *making it impossible to identify taxpayer's operations.*

After the Administration has performed the tax assessment on a presumed basis, there is still a responsibility outstanding for the differences that may come up from a later assessment on certain basis practiced in a timely manner.

The assessment described in this article could not be challenged based on the fact that the taxpayer has not informed the Administration in a timely manner.

Grounds for actions (Art. 76)

It is established that the *events that are learned as a result of the examination* or that are included in the documents the Administration has *may serve as grounds for its resolutions.*

Validity of the information supplied by foreign tax authorities (Art. 77)

It is established that to assess omitted taxes or to impose penalties, *the Administration may consider as truthful the events or omissions known from foreign tax administrations,* except as proven otherwise by the taxpayer.

International administrative assistance (Art. 78)

The tax Administration is empowered to *conclude international agreements of tax information exchange,* provided that reciprocity is ensured and the other contracting State guarantees that the information and data will not be used for purposes other than tax or tax-criminal procedures. This information and data will only be accessible by those competent persons in the field of taxation or in the prosecution of tax crimes.

Measures involving legal proceedings for collection (Art. 79)

It is established that at the request of the tax Administration and after being summoned by it, Ordinary Justice might order the *arrest of the offender, as a measure involving legal proceedings for collection,* in order to obtain compliance with the tax obligations imposed by tax provisions.

Causes for the application of the legal proceedings for collection (Art. 80)

Legal proceedings for collection will be undertaken against the persons who:

1) Having been *summoned for a second time by the tax Administration fail to appear in court without a justified cause.*

2) Obstruct the proceedings launched by the tax Administration in the exercise of its examination powers.

Precautionary measures (Art. 81)

It is established that the tax Administration might practice a *precautionary embargo over the assets of the taxpayer or third responsible party for the amount that he presumably owes or, alternatively, the general inhibition of assets,* prior to the date on which the tax credit is assessed or required. Such measure might be applied when in the Administration's opinion there is the danger that the taxpayer may fail to show up or sell or conceal his assets.

These measures will be proportional to the damage the Administration is trying to prevent and under no circumstance will those that may generate damage difficult or impossible to repair be adopted.

ii. Obligations of taxpayers and third parties for the facilitation of the examination

Facilitation of examination (Art. 51)

It is established that the taxpayer, third responsible and third parties are obliged to *facilitate the tasks of examination* that are carried out by the tax Administration in the fulfillment of its functions:

1) In particular they must:

   a) *Support all operations* of sale, transfer and rendering of goods and services through receipts issued in a legal manner.

   b) *Maintain* general and special *books and records* dealing with the activities and operations related to taxation that are established in each case.

   c) *Register in the pertinent registries*, providing the necessary information and communicating modifications in a timely manner.

   d) *File the returns and information* that are required.

   e) *Facilitate access to information on his financial statements in banks and other financial institutions.*

2) *Maintain in an orderly fashion* for a period of ....years the accounting books, special records and all the *documentation* pertaining to the operations and transactions that constitute taxable events or that are related to the same.

   The data storage media used in computer systems will be maintained for a similar period of time in operating conditions to process information related to tax issues.

3) *Facilitate the management of tax officials* authorized in any of the places where examinations, inspections or audits are practiced.

4) *File, display and make available* to the offices or officials of the tax Administration the tax returns, reports, vouchers and *all documentation substantiating* the operations and transactions that constitute taxable events or that are related to the same.

5) *Provide a copy of all the storage media referred to in the second paragraph of point 2),* with the tax Administration being obliged to provide the corresponding inputs.

In addition, the Administration *must make all the information and documentation related to the computer equipment and system programs (or basic or elementary software) available, along with the application programs (or application software) that are used in the registration and accounting computer systems* of operations related to tax matters. This must be done whether the processing is done using their own or leased equipment or third parties render the service.

6) *Allow the use of programs and application utility features in tax audits belonging to the tax Administration, in their own computer services or those of third parties,* at a time the normal development of the taxpayer activity is not obstructed.

7) Communicate any change of situation that may give rise to the alteration of their tax responsibility, changes of line of business, cease of activities, transfer of assignment of assets, transformation of corporations and the like.

8) *Maintain always available* to the tax Administration in the tax domicile or the place where its business or professional activities are conducted provided it is different, the *tax returns, accounting books and records, vouchers and other documents* supporting its activities.

9) *Appear before the tax Administration offices* when formally summoned.

Registration (Art. 52)

It is established that all individuals and corporations, and the entities and groups without legal status, that by virtue of their activity or condition are potential taxpayers of tax obligations, must join the National Tax Registry. They must provide the data that are required and keeping them permanently updated in the form and condition established by the tax Administration.

Information (Art. 53)

It is established that:

1) *The taxpayers, third responsible or third parties alien to the tax relationship, individuals or corporations and economic units or collective entities, whether Public or Private, are obliged to cooperate with the tax Administration in the function of examination. They must provide to the tax Administration all kinds of data, reports or tax background information from their economic, professional or financial relations with other persons, which are required* by the aforesaid Administration.

   In accordance with the provisions of the aforementioned paragraph, in particular:

   a) *Withholding agents* and those required to make payments are obliged to present information on *amounts paid to other persons* for work income, capital income, and business or professional activity income.

   b) *The corporations, associations, professional associations or other entities that among their functions make the collection on behalf of their partners,* associates or association members of professional and other fees from intellectual or industrial property or copyrights, will be obliged to *take note of that income and inform the tax Administration thereof.*

      Those persons or entities, including bank, credit or financial entities in general will be subject to the same obligation, provided they statutorily or customarily manage or intervene in the collection of professional fees or commission. This involves the *activities of receiving, placing, assigning or mediating in the capitals market.*

   c) The persons or entities that *store money in cash or accounts, securities or other assets of debtors of the tax Administration* that are in the process of tax execution, will be obliged to *report to the organs and legal collection agents.* They will also be obliged to comply with the requirements that are made by them in the exercise of their legal functions.

2) The obligations described in the preceding paragraph must be fulfilled, *whether in general or following a request from competent entities* of the tax Administration, in the manner and terms established by regulations.

3) *Noncompliance* with the obligations established in this article *will not be covered by bank secrecy* or such provisions as internal regulations for the creation or functioning of the aforesaid organizations or state or private entities. Such obligations must be promptly observed, in the manner established by the tax Administration.

   Individual requirements relative to the movements of checking accounts, savings and time deposits, loan accounts and credits and other active and passive operations will be made following an authorization from the competent official of the tax Administration. They include those involving temporary accounts and the issue or checks or other payment or charge orders on account of the entity, Banks, Savings Institutions, Credit Cooperatives and individuals or corporations devoted to bank or credit movement. *Individual requirements must specify the identification data* of the check or payment order, or the operations being investigated, the taxpayers affected and the investigation period of time.

   The investigation made in the course of examination actions to regularize the tax situation in accordance with the procedure established in the preceding paragraph may include the origin and destination of the movements or the checks or other payment orders. However, in these cases it may not go beyond the identification of persons or the origin or destination accounts.

4) The obligation of the *professionals* to facilitate information of tax significance to the tax Administration *will not include the private data, not involving capital, that are known by virtue of the exercise of their activity,* the disclosure of which may affect the honor or personal and family intimacy of persons.

   Professionals will not be able to invoke professional secrecy for the purpose of preventing the examination of their own tax situation.

Officials from the public sector and other entities (Art. 54)

It is established that the authorities, at all levels of the State political organization, regardless of their nature, chiefs or heads of civil or military offices of the State and other territorial public entities, autonomous organizations and state corporations; the Chambers and associations, professional groups and societies; Social Security Funds; other public entities including Social Security institutions and those who exercise public office, will be obliged to *provide to the tax Administration the tax information and data they may gather. This will be effected through general provisions or specific requirements; they will also be obliged to assist and cooperate with the tax Administration and its agents in the protection of the exercise of its functions.*

In addition, they must report to the tax Administration the tax crimes that they learn in the performance of their duties.

Political parties, unions and business associations will be subject to the same obligations.

Courts and tribunals must facilitate to the tax Administration, at the government or Administration's request, important tax information dealing with judicial actions respecting, at all times, secrecy in judicial proceedings.

In keeping with the preceding article, preceding paragraphs of this article of legal norms, *the assignment of personal information that must be made to the tax Administration, which is handled in an automated manner, will not require the consent of the affected party.*

b. Limitations

In addition to the powers established in the CIAT Tax Code Model, provisions that can be construed as specific limitations or requirements for the exercise of such powers are also included. Said powers are sometimes included in the provisions establishing them and, in particular, in those governing the obligations of the administration, the very examination procedure and those dealing with the statute of limitation.

i. Obligations of the administration

Taxpayer assistance (Art. 87)

The tax Administration will provide assistance to taxpayers. To that end, the Administration will *specify the requirements* urging taxpayers to file tax returns, communications and other documents they must present.

Secrecy of tax information (Art. 90)

It is established that the officials who intervene in the different formalities relative to the application of tax provisions and the owners and employees of contracted collaborating entities, will be obliged *to keep absolute secrecy regarding the returns and data supplied by taxpayers*, third responsible or third parties. They will also be obliged to keep secrecy regarding the information obtained in the conduct of their examination powers. Such *secrecy will not include* the cases in which the tax Administration must provide information to:

1) *Judicial authorities in dealing with the criminal proceedings or competent Courts handling child support cases.*

2) *Other entities handling taxes*, provided that the information is strictly related to the examination and perception of taxes in their corresponding jurisdictions

3) *Tax administrations from other countries* in keeping with international tax information exchange agreements and other assumptions listed in this Code.

ii. Procedure for examination

Formal requirements (Art.113)

It is established that *external examination* in the domicile or establishment of the taxpayers or those responsible will be carried out in accordance with the following rules:

1) Every external examination action must be based on an *order to take action from a competent authority* of the tax Administration. Such actions must be geared toward examining the individual, taxpayers or third responsible parties as well as the places where the examination is to be effected. They must also identify the official(s) in charge of the tax examination action.

   When the person occupying the estate or building under whose custody is the taxpayer, opposes the entry of examination officials, they may carry out their work by directly requesting the assistance of the public force. *When dealing with the home of the taxpayer or third responsible party it will be necessary to previously obtain a judicial order.*

2) *Every action will be documented in minutes,* which will list how events unfolded and the omissions tax auditors found. The events or omissions determined by tax auditors, when not contested by the audited party, will corroborate the existence of such events or omissions found, for the purposes of any of the taxes for which the audited party is responsible. They will cover the reviewed period, although such purposes are not expressly specified.

   The events specified in the actions described in the preceding paragraph will be deemed as accepted, provided that before closing the final minutes the taxpayer does not present the reference documents, books or records. This will also hold true provided that the taxpayer does not specify the place where such records may be kept, for as long as this is the tax domicile or the place authorized to keep his accounting.

   It will be up to the taxpayer or responsible party to prove the truthfulness of his tax returns or the nature of background information and amounts of transactions with documents, accounting books or other means established by the norms, provided they are necessary or mandatory for the taxpayer.

3) During the conduct of examination by auditors, in order to ensure the accounting, correspondence or properties that are not registered in accounting records, they may seal off

or place markings on said documents, properties or real estate, files or offices they may be in. They may place them as deposit under the audited party or the person being examined following the write up of an inventory. In the *event some document that is in the real estate, files or offices that are sealed off is needed by the audited party for the conduct of his business, he will be allowed to get them in the presence of auditors.* Auditors will be entitled to make a copy of such document and record this event.

The last partial minutes that are drafted will make express mention of such circumstance and between them and the final minutes there may at lest pass ..... days, during which time *the taxpayer or third responsible party may accept totally or partially the events or omissions determined by tax auditors.*

4) *If when closing the final minutes of the examination the audited party or his representative were not present, they will be served a summons to be present at a specific time the next day.* Should he not show up, the final minutes will be drawn up before whoever may be present at the examined place. At that time any of the auditors who has taken part in the examination and the audited party or his representative will sign the minutes, a copy of which will be given to the audited party. If the audited party or his representative fail to appear to sign the minutes, refuse to sign it, or the audited party or his representative refuse to accept a copy thereof, such event will be recorded on the minutes without it affecting its validity and proving value.

iii. Statute of Limitation

General Term (Art. 42)

It is established that after .... years the following rights and actions will *expire:*

1) *The right of the Administration to assess the obligation and ensuing surcharges and interest;*

2) *The action to impose tax penalties;*

Extension of the term for the statute of limitation (Art. 43)

It is expected that the term for the statute of limitation *will extend* to ..... years when:

1) The registered taxpayer or third responsible party *does not comply with the obligation to declare the tax-generating event, or of filing tax returns for two fiscal periods.*

2) *In the cases of tax assessment by the tax Administration, when it was unable to learn the tax-generating event following its concealment.*

3) *When the taxpayer or third responsible parties have extracted from the country the assets subject to the payment of tax debt, or it involves tax-generating events related to actions carried our or properties located abroad.*

4) *When the taxpayer does not keep accounting records, does not keep it for the required term or maintains double accounting.*

Interruption of the statute of limitation (Art. 45)

It is established that the statute of limitation is interrupted *by any administrative action* carried out with the formal knowledge of the taxpayer, leading toward the recognition, regularization, examination, securing, verification, assessment and collection of the tax earned for each taxable action.

Suspension of the statute of limitation (Art. 46)

It is established that the estimation of the term for the statute of limitation is suspended for failure to comply with the obligation to register with the pertinent registries and will extend until the formal registration of the taxpayer or third responsible party.

CONCLUSIONS

1. The legal powers of the tax Administration for the development of its functions constitute a conditioning factor of its performance, which is of great importance. Should it not be adequately contemplated, especially insofar as the sufficiency of those powers, it will mean that the intent of the Administration to apply taxes effectively will not be attained.

2. Moreover, given that this involves the exercise of the examination function in which the actions of the administration contradict the interest of the audited parties and may imply activities to be carried out in its establishments and domiciles, the granting of legal powers for that exercise is fundamental.

3. On the other hand, the function of examination is directly related to the strategic objective of promoting voluntary compliance with tax obligations. The facilitation of voluntary compliance along with the function of examination constitutes an element that furthers the importance of attaining that objective.

4. As part of the necessary powers for the exercise of the examination function, dealing with obtaining, accessing and using information from taxpayers or third parties have a special importance. In essence, the examination function is geared toward corroborating the veracity of the information supplied by the taxpayer and obtaining the information the taxpayer may have omitted or concealed.

5. Also, although sufficient legal powers have been granted, their incoherent structuring will make the work of the Administration difficult and will promote juridical insecurity for taxpayers.

6. To determine the legal powers of the tax Administration, it is essential to take into consideration their compatibility with the positive juridical order in which they are established, in particular with constitutional provisions. Consequently, the exercise of these powers will not become a significant source of conflict in treasury-taxpayer relations, without benefiting both parties.

7. It will also be necessary to consider the characteristics of the tax system and each of the taxes comprising it, which may require certain specific powers for the tax Administration in charge of examination.

8. In addition to the juridical framework of the legal powers of the tax Administration, it is necessary to consider other circumstances for its definition. In this case, they deal with the atmosphere in which the Administration must operate and the degree of development it has attained. Regarding the atmosphere in which the Administration operates, the extent and structure of the economic system of the country and the magnitude and education level of taxpayers should be taken into consideration. Regarding the degree of development it has attained, the resources the tax Administration has should be taken into consideration, in particular the technical-professional level, integrity and motivation of Administration officials.

9. The CIAT Tax Code Model offers a framework of reference that may serve as basis for the improvement of the norms governing the powers of the tax Administration in general, and for the exercise of the examination function in particular. This holds true provided that the improvement is necessary and the country so understands.

10. At the same time, when considering the powers that may be deemed necessary for an efficient and effective performance of the tax Administration, that Model may be used by tax administrations of CIAT member countries. The purpose of this would be to compare the legal powers granted by positive law and reach conclusions on their adequacy and sufficiency.

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Case study:

TOPIC 3.2

RISK ANALYSIS AS INSTRUMENT FOR GUIDING EXAMINATION

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ABSTRACT: The Dutch Tax and Customs Administration has in its operational management opted for making a distinction between four main target groups: private individuals, companies, large companies and customs. The scope of this essay about the use of risk analyses as instrument for guiding examination is limited to the target groups companies and large companies.

The tax administration of today operates in a dynamic and fast changing society. Developments such as computerisation and internationalisation continuously create new risks and affect existing and identified risks. The same applies to changes in the (tax) legislation and fiscal policy. In addition, the expectations and demands of citizens from government change over time.

Therefore, major inputs for identification of risks are provided by trend and environment scans, risk-oriented analyses of new legislation and signals from the 'field', that is from tax officers directly

dealing with clients. We also make use of data provided by third parties and data provided by the taxpayer himself, for example in his tax return. All these inputs may indicate the emergence of new risks, new client groups, or new characteristics of existing client groups.

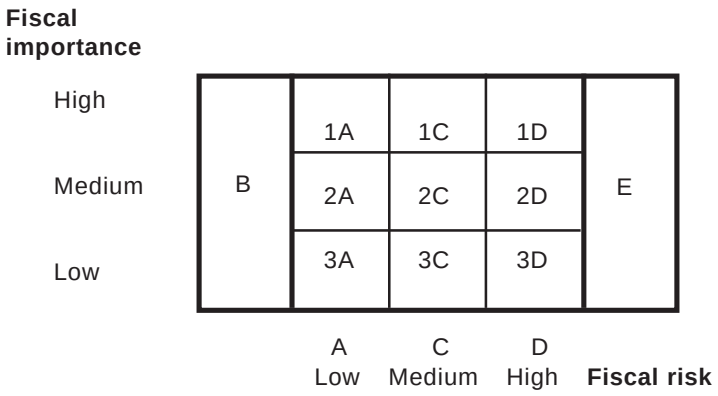
Within the client group companies and large companies, we make a distinction between risks that may occur in all economic sectors and risks that are limited to one or a few. For example, the risk of a too low declaration of sales by an entrepreneur can occur in practically all sectors. On the other hand, the risk that the sale of milk quotas will be incorrectly processed for tax purposes occurs only in the dairy sector. It might also be the case that the scale of a risk or the possibility of detecting a specific risk will vary from one sector to another. Therefore, the Dutch tax administration uses a four-digit code to identify all the different sectors, all with their own risks.

The hundred largest or most fraud-sensitive sectors are ‘adopted’ by an average of three tax units. This system is known as target-group adoption. Almost 65% of all firms in the Netherlands are situated in these hundred adopted sectors. The teams within the tax units involved in the target-group adoption describe the risks specific to the sector in question. These risks are known as ‘sector-dependent’ risks. Conversely, risks that might occur in all sectors are known as ‘sector-independent’ risks. The latter are identified by so called portfolio holders. Portfolio holders are staff members who are responsible for the quality of the implementation of tax laws and tax policy from a technical and legal point of view. At present, the portfolio holders have identified more then 30 general, sector-independent risks. Besides the aforementioned risk of a too low declaration of sales by an entrepreneur, other examples of sector-independent risks are double tax returns on dividends, negative operating profits, random debiting, large deductions on extra burden of taxation, wrongful use of fiscal facilities, overvalue of goodwill, improper division of business versus private matters, and so on.

Once a risk has been detected, action is not always necessary. This will depend on the scale and extent of the risk and the integrity of the taxpayer concerned. Therefore, risks and clients must be ‘weighed’. In addition, choices have to be made as only limited capacity and resources are available. And finally, choices have to be made with regard to which risk must be reduced and to what extent.

To facilitate these choices, risks must be compared on basis of objective characteristics. This means that frequencies of risks must be determined or estimated: how often does a particular fiscally relevant event occur which entails a specific risk? Also, the gravity of the risk must be established: how often do problems arise after the relevant event has occurred? Finally, the monetary importance of the consequences of a risk must be assessed: how much tax will be forgone? This is called the extent of the risk. Insight into these aspects is crucial for making justified choices.

Not only the risks, but the clients too must be weighed in terms of their (fiscal) importance and the risk they entail. It must be determined which criteria are relevant and what weight should be given to these criteria. An example of how clients are weighed is the ‘attention category’, which the Companies and Large Companies Divisions of the Dutch Tax Administration uses.



The attention category is a combination of two components: the risk class and the fiscal importance class. Based on objective criteria, eleven different attention categories have been identified.

The risk class gives an indication of the tax behaviour of an entity and is made up of five categories: three regular categories (A, C and D) and two special categories (B and E). Entities in risk class A present a relatively low tax risk, while those in class D present a

high risk. The fiscal importance class indicates the amount of tax paid by an entity and comprises three categories: high, medium and low.

Business start-ups (B) and businesses that are currently under fiscal investigation (E) each make up a special attention category.

How are the eleven attention categories determined? A firm's importance in terms of tax revenues, that is the vertical axis of the attention category model, is easy to determine on basis of the amount of tax revenue to which it annually gives rise. More specific, it is the sum of corporation tax, income tax, wage tax and turnover tax.

Based on this information, we formulated three importance categories:

1. Low importance companies: annually less than 10.000 euros tax revenue

2. Medium importance companies: annually between 10.000 and 35.000 euros tax revenues

3. High importance companies: annually more than 35.000 euros tax revenues.

The horizontal axe, that is the fiscal risk of a corporation, is designed to take objective account of the tax conduct of a firm. This is done using several indicators to which penalty points are attributed. Entities in risk class A present a relatively low tax risk, entities in risk class C present a medium tax risk, while those in class D present a high risk.

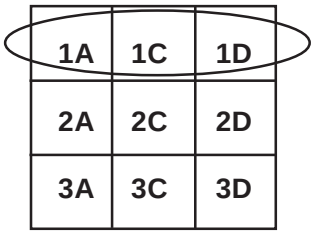
As stated, business start-ups make up a special attention category. Too little is known about them to place them in the right category. No information is available either about their fiscal importance. The second special category, the E-category, is made up of entities which are actually under criminal prosecution. The fraud element is predominant for entities in this category.

We use many different indicators to take objective account of the tax conduct of a firm. A few examples of the used indicators are:

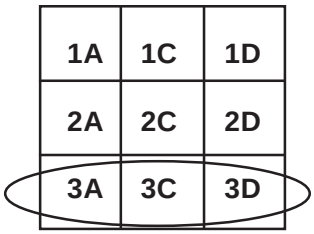
1. The quality of the administration of a company;
2. The specific sector risks of a company. This is an index determined objectively for all sectors on the basis of the correction results of tax controls carried out in the past;
3. The tax complexity of the company;
4. Regularity of returns for all resources over the last twelve months;
5. Official assessments in the last completed year;
6. Substantive corrections in in-the-field checking;
7. Corrections in in-office checking;
8. Supplementary payment of VAT/Wage tax in the last calendar year;
9. Regularity of payment over the last years;
10. Responding in time to a request for information by the tax administration;
11. Refusing a preliminary consultation offered by the tax administration;
12. Detection of fraud, notified by the Fiscal Information and Investigation Services Department;
13. Business start-ups.

How does the Dutch tax administration treat taxpayers in each of the different attention categories? The basic principle is that the Dutch tax administration will pay more attention to an entity if it is of greater fiscal importance and its tax behaviour is worse.

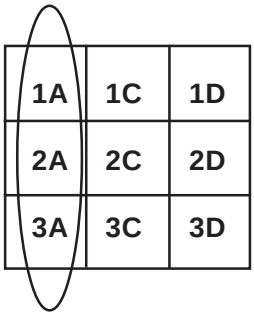
Within the nine regular attention categories, four basic groups of firms can be identified. Specific aims, and consequently specific attention approaches, are formulated for these groups at a strategic level.



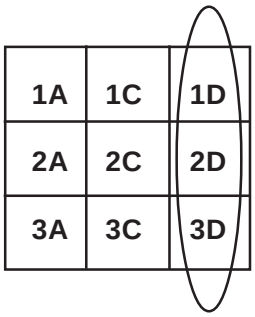
In the upper row of the matrix are those firms whose common characteristic is that each year they make a considerable contribution to the State exchequer. From the point of view of tax revenues, they are an important group. The tax administration's main aim in respect of this group of taxpayers is to ensure that this contribution is maintained. The core elements in the processing strategy of these firms are consideration for the relationship and actively providing them with information. This also means that we must ensure that companies in these attention categories stay on the right path as far as their tax behaviour is concerned. This group therefore requires that we give them considerable attention.



The companies in the bottom row have in common that the scale of their activities is so small that the tax revenues from this group is limited. The interest of the Dutch tax administration for this group is therefore also relatively small. This group is mainly made up of firms that might and should grow to higher levels of activity. The aim of the tax administration is therefore to offer them the facilities to develop within the limits of their existing possibilities. Simplified processing and dealing with specific requests for information is therefore given priority.

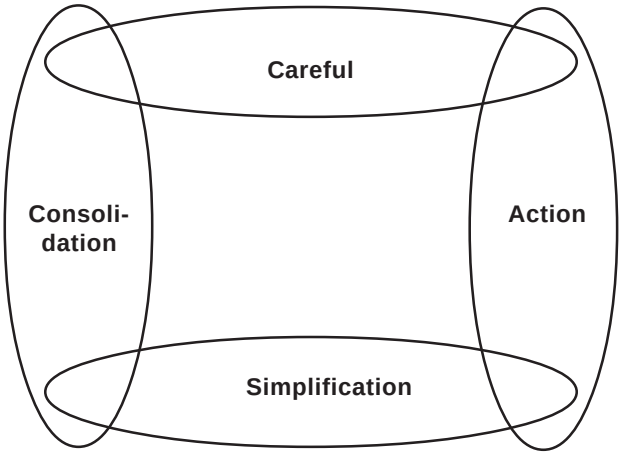


The tax risk of the group of firms on the left-hand (A) column is relatively small. The amount of attention paid to them by the tax administration is consequently also limited. The aim with regard to this group of firms is to ensure that their compliant behaviour continues. The key word is ‘consolidation’ of their good behaviour. This means that companies must be made aware in a positive sense that they belong to this group. They must see themselves as being in a ‘win-win’ situation. This can be done, for example, by limiting inconvenience on our side, ensuring extremely short turnaround times, etc.



The final basic group is the companies situated in the right-hand (D) column. The main characteristics of this group are the high level of risk and the, sometimes considerable, loss of tax revenues this entails. The aim with this group is to improve behaviour, to try to ensure that they submit reliable returns and pay the resulting tax debt. This means considerable attention, both ongoing and repressive, is necessary.

The determining characteristics of the attention to be given to the different groups of taxpayers can be summed up as follows:



Of course, the simplicity of this characterisation of the required attention also makes it something of a caricature. This is because a firm will in fact belong to two of these groups. The ultimate attention that will be given will be made up of a combination of several basic characteristics.

Furthermore, the middle category, 2C, is not given any characteristic. The attention paid to these 'average' customers will be made up of a combination of several basic characteristics.

An example of a processing strategy for this attention category is:

-	Active information	10%
-	Ongoing supervision	15%
-	Automatic completion	40%
-	In-office checking	35%
-	In-the-field checking	25%
	=	100%

Alongside the nine regular attention categories, there are the two special categories B and E. The business start-ups are subject to particular risks, such as the high change that they will inadvertently

make errors, for example at the level of administrative organisation, the filing of tax returns and the paying of tax debts. Specific risks also exist where there is a question mark over whether a firm is able to finance its opening balance. Finally, start-ups also represent a particular risk at the level of tax collection since many of them cease trading within a short period because of unsatisfactory profits. The processing strategy consequently provides for a relatively intensive attention during the start-up period, for example by means of a visit to the firm. This gives an opportunity for information and assessment activities to be carried out.

A special strategy has also been developed for the limited group of entities belonging to attention category E. These entities are characterised by the fact that one or more risks are covered by means of an approach based on criminal law. For the other risks, processing comparable to that of attention category 1D is possible.

The following table provides an impression of the distribution of firms over the various attention categories in the Netherlands:

Attention category	Percentage of firms
B	14
1A	8
2A	11
3A	30
1C	10
2C	8
3C	15
1D	1
2D	1
3D	1
E	<1

Finally, it should be pointed out that an individual approach is determined for the 1000 largest firms in the Netherlands. Within the main target group Large Companies, taxpayers are divided in three categories based on scale (= fiscal importance) and fiscal complexity (= fiscal risk). Category 1 includes the top 200 companies of the

Netherlands, category 2 includes the 201-600 companies and Category 3 includes the remaining group large companies. The client handling of companies from categories 1 and 2 are made-to-measure and based on an individual handling plan. The handling of entities from category 3 is in principle similar to the handling of entities of the target group companies.

Within the target group Large Companies, the Dutch tax administration has also opted for a national concentration of a limited number of target groups: banking and securities industry, insurance companies, oil and gas, ruling and professional soccer.

The level of a risk (that is how often will things go wrong), the scale of a risk (which is the amount of money involved) and the relevant attention category for a taxpayer, are determined as much as possible with the help of a central automated assessment, based on so called parameters or limit of tolerance. The 'harsher' the processing strategy of the tax administration, the lower its parameters. In doing so, relatively more risks are signalled for the attention category. This way a processing strategy consistent with the level of risk is determined: the greater the importance or risk, the more attention is given.

Sometimes it may be necessary to upgrade the detected data by applying a 'rule of knowledge', for sharpening the detection and increasing the probability of finding an irregularity. By using specific parameters or tolerances, the outcome of the rule of knowledge is attuned to the treatment strategy for the specific client (or group of clients) and the available treatment capacity. The application of rules of knowledge and parameters also ensures that equal cases are being treated equally.

For instance, the detection of a too low declaration of sales by an entrepreneur can be detected in the relationship between total wages and sales. First step is to develop a rule of knowledge which lays down that relationship in quantitative terms. A parameter would indicate the tolerance when the result of the rule of knowledge deviates from the standard. A larger tolerance results logically in fewer taxpayers or events being marked as problematic. A parameter could also be a threshold in the form of an amount of money. For instance, if the proceeds of the sale of property are below a certain amount, no intensive tests will be carried out. The threshold amount

could vary with the fiscal behaviour of the client. Thus, for a client with a high fiscal risk the threshold would be zero, with the effect that all property transactions by this group of clients would be marked for intensive surveillance.

As soon as a parameter is exceeded, the staff member automatically receives a signal from the system. Depending upon the importance of the risk and the client, which is incorporated in the knowledge rule and the parameters, the reception of this signal may or may not result in intensified surveillance. If intensive surveillance is indeed required, the signal is passed through to the tax officer to whom the taxpayer has been assigned. Our aim is of course that the filtering of signals is optimal, so that those signals which occur really do require the control agent's attention.

The ultimate aim of the whole process – the identification of risks and the weighing of these risks and the clients they apply to – is dealing with the signals. Because that is what it is all about: using risk analyses as instrument for determining the control of different groups of taxpayers.

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Case study:

TOPIC 3.3

STRATEGIES FOR DETECTING AND INCORPORATING THE UNDERGROUND ECONOMY

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CONTENTS: Informal Labor or Informal Economy.- Fiscal Pressure in Italy and Distortions.

Adam Smith upheld that public revenues were justified to the extent there was a public expenditure for the administration of justice, for carrying out great civil works, for ensuring adequate military defense. The State, accordingly, must have available sufficient income for its normal operation. The dimensions that such State has acquired little by little, along with the relevance and importance of public administration, have required that tax revenues acquire characteristics of certainty and regularity, thus determining the structuring of tax systems based on the coercive nature of the tax. Tax power has become the expression of state sovereignty for financing works and services of general interest, initially mainly managed by the same public entity and subsequently, also granted to private entities.

The Italian tax system is based specifically on a standard included in the Constitutional Charter, which provides that “all are obliged to share public expenditures according to their own taxpaying capacity”.

Such standard states and upholds two interests of equal rank, although fundamentally different among themselves: that of an organized collectivity wherein all its components must obligatorily contribute to the collection of the necessary financial resources for the aforementioned public expenditures, expression of political and social solidarity, and that of the individual who, as taxpayer, always calls for respect of his own taxpaying capacity. That is, that he be guaranteed and be the object of equitable tax collection. The term "all" found in the constitutional rule and which indicates the subjective sphere of application goes well beyond the traditional concept of "citizens", inasmuch as it rather refers to all those who in some way enter into contact with the State's law.

To this particular determination of the scope of application of the constitutional principle being examined, one may add the principle of "territoriality" of the tax, which is the basis for the systematic structuring of the tax rules in force for those who are not foreign to the territory. Finally, the confirmation of the "obligation" to contribute is contained in the expression "are obliged".

Since remote times, discussion of the tax issue has aroused the interest of public opinion. The application of taxes irritated the ancient Egyptians more or less to the same extent they irritated the peasants of the Middle Ages with respect to the fiscal pretensions of the feudal lords. In recent years, there has been a significant change in the fiscal policy-citizen relationship: the period of rebellion of the masses has precisely produced, a resolutely original phenomenon in the history of humanity: the ever more generalized disapproval of the Treasury by the taxpayers.

It is a phenomenon that interests all the more industrialized countries and subjects them to continuous political tensions, under different forms and modalities. As compared to the past, today's taxpayer is much more informed, mobilizes himself easily and above all, struggles with greater energy to achieve, maintain and improve his own "competitiveness", even the fiscal one. On the other hand, he is ever less willing to silently observe the incorrect use of the scarce resources available, without diminishing his fair expectation for better and more numerous public services, stressed, of course, by globalization, not only economic, but of our society.

No less significant changes intervened in the statistical representations of the different levels of income: the primitive

pyramid, expression of a distribution of income of a pyramidal type, where a significant part of resources were concentrated on a few individuals, has been progressively substituted with a representation in the form of a rhombic structure, which concentrates most of the wealth produced in the intermediate levels, with a progressive erosion of presences in its inferior and superior vertices.

The development of a new “middle-high class” has resulted in changes of fiscal policy of some relevance, with the weakening of the spirit of solidarity and redistribution of wealth among the different levels of income and with a new political perception, or sensitivity, that tends to interpret most fiscal measures as an unfair subtraction and transfer, of resources to the detriment of the “middle-high class”, which, of course, feels most threatened by the aforementioned economic globalization. The protest and, at times, “fiscal disobedience” expressed by the most extremist parts of this portion of the population are nourished from the sensation, this time diffused among a large proportion of the people, of being excessively and accordingly, unfairly participating in the financing of public expenditure, especially because many, or too many, in all or in part, fail to comply with their own tax obligations.

INFORMAL LABOR OR INFORMAL ECONOMY

The creation, expansion and strengthening of a true informal, alternate economic system, in counterposition to the normal system of economic and commercial relationships that characterize our society, may also be considered as the reaction to a tax system perceived as unfair and unbearable. Of course, the passage of economic operators, or of simpler taxpayers, from one area to the other of a society’s economy causes and immediate, and not in the least insignificant erosion of collection.

On the other hand, to the extent that the volume of public expenditures –and, more in general the number of goods and services which the “Social State” must provide its citizens – cannot be compressed beyond the line of political sustainability and social consent, there may be an increase in the tax burden with the subsequent, perverse consequence of more energetically promoting the passage of economic activities from the area of legality to that of illegality.

The relevant presence of informal labor may additionally pose serious problems for the correct identification of economic and fiscal policy data, to the extent that indicators adopted, for example, those relative to the volume of collection, to the levels of occupation or estimation of fiscal evasion, may be altered. Because of its very nature, a strong, informal economic component subtracts from the elements of evaluation of the official economy, since income derived from the informal market is introduced in the official circuits and in the same manner is reinvested in the same informal economy.

Whoever is in charge of elaborating fiscal policy must also be aware, not only of the dimensions of the economy and informal labor, but also of understanding the causes and consequences, in order to implement the most effective measures for curbing this particular economic activity and prevent it from developing. These cognitive demands and the need to intervene as soon as possible in the most energetic manner have generated an increasing number of studies bordering between sociology and economics that have endeavored to use research methodologies for individualizing informal labor and measuring its causes. Nevertheless, all have obviously confirmed that field research in relation to this issue is extremely difficult, due to the fact that the participants in the informal economy tend to conceal their activities and have very strong incentives for not disclosing the consistency and dimensions of their economic interests.

As far as Italy is concerned, the literature on the subject highlights the marginality of businesses as one of the determining factors in resorting to informal labor. That is, those small or very small and noncompetitive businesses which, placed in a marginal position within the complex structures of sub-provision, resort to informal activities to guarantee their survival, or at least to achieve acceptable margins of income, through the advantages resulting from fiscal and taxpaying evasion.

A speedy analysis of some of the characteristics of the microeconomic models used as basis of the two main explanations of informal labor; one based on tax behavior and the other, on the operation of the labor market, may be useful for better understanding the assumptions, implications and limitations in relation to, empirical studies performed on the basis thereof, as

well as the guidelines of economic policy which the different experts have suggested. Naturally, both explanations may jointly contribute to the reconstruction of the dynamics that determine the entity and the characteristics of informal labor, while constituting alternate bases for the two main methods of quantitative estimation of the phenomenon.

The explanations based on fiscal behavior refer to models of worker-taxpayer behavior wherein, along with the alternative between working and not working, the option which maximizes earnings also consider the possibility of evading taxes. This third possibility introduces an important element of realism, linked to the growth of fiscal pressure in the industrialized countries and the presence of irregular exchanges in the labor market.

The decision to evade taxes from the standpoint of the worker-taxpayer occurs in conditions of uncertainty, represented by the more or less high probability that his behavior may be discovered. The cost of the decision to evade is, therefore, determined by the fiscal risk, consisting of the probability of being discovered and the level of sanctions imposed to the evaders.

The attention focused on the characteristics of the labor market have given way to models that have been particularly successful in Italy, especially during the initial investigations of the subject, which related the presence of informal labor to the diffusion of productive decentralization in the small business and autonomous labor, that were, in turn, represented by most scholars as reactions to the rigidity of the labor market in the particular phase of economic recession which took place in the seventies.

In addition to these types of models, it is possible to individualize other important aspects that may intervene in the decision to participate in the informal economy, such as the nature of the market wherein the worker chooses to carry out his tasks (of free competition or almost monopolistic), the qualitative characteristics of the work and its influence, etc.

There are other factors, among which in particular, the level of unemployment, the per capita income available and the level of “fiscal morality” have been pointed out as important indicators of the presence of informal labor, at times attributing to them, more or

less implicitly, an explanatory function, even without managing to establish a direct relationship between them and the informal activity itself.

The initial studies devoted to the analysis of the informal economy date back to the seventies, when in Italy, as in other countries with an advanced economy, a certain number of applied investigations and some theoretical ones, were undertaken, jointly with the first attempts at providing solutions in the sphere of economic policy orientations.

In general, the interest for the informal economy has followed two paths of specific research; one centered on tax evasion, and the other, on the operation of the labor market. These two spheres of research correspond to two of the most important aspects of the problem of the informal economy, either from the standpoint of individualization of the main causes, as well as of the effects produced in the sphere of the national economic system. Added to this in the course of the nineties, has been the need to review the survey techniques within the sphere of national accounting, which has been particularly felt in the countries of the European Union for the purpose of improving the comparison between the economies of the countries adhered thereto.

While empirical studies in Northern Europe and the United States have been focused on the analysis of tax evasion, also from the standpoint of the measurement methodologies adopted, with the analysis of distortions transmitted by it to the status of macroeconomic aggregates within the national sphere, in Italy, on the contrary, greater attention has been given to anomalies occurring in those years in the dynamics between the labor demand and offer and in the force-labor behaviors.

In Italy, research of informal labor is linked to the analysis of a phase of the country's economic life which is characterized by a firm reduction of the rates of activity to unreal levels, an industrial restructuring based on productive decentralization and the renewed role of the small business and work at the domicile, with new characteristics, including its transformation into autonomous labor.

Initial research on informal labor precisely focused on the relationship between the diffusion of productive decentralization

and the strong divergence between official results and the reality of the labor market, by advancing critical or structural interpretations of decentralization and evidencing with respect to the latter, phenomena of segmentation of the labor market.

If, accordingly, in the seventies and eighties, empirical research on informal labor was framed within the analysis of the transformations of the organization, characterized by the trend toward decentralization and intermediation of the economy, in more recent times, the problem of the presence and dimensions of the informal economy has again called the attention of politicians and economists, especially in relation to its fiscal effects, whose weight, vis-à-vis the new balance relationships determined by the adhesion to the treaty of Maastricht, has become particularly relevant for the treasury of a strongly indebted state such as Italy.

The growth of the informal economy represents, in fact, from the fiscal standpoint, the core aspect of a possible vicious circle between erosion of the tax base, reduction of fiscal revenues and subsequent aggravation of the balance's deficit, with the possibility of an increase in rates, whose substantial effect could be nothing less than a progressive growth of the same informal economy, with the repetition of the negative sequence.

The renewed interest for the fiscal and economic effects of the presence of the informal economy has also promoted comparative research, carried out within the sphere of the countries of the European Union as well as in the international sphere.

On the other hand, the launching of the single currency imposes a strong qualification to all the European productive and social systems, on penalty of being left outside the economic system. This has called, not only for responding to the criteria of Maastricht in relation to public debt and inflation, but also to orient oneself toward the objectives of productive innovation and social qualities indicated since 1993 in the so-called "White Book" of the European Commission. In Italy, where already there is a strong differentiation between strong and weak areas, between productive systems of quality and entire regions facing the phenomena of illegality, "social dumping" and underground labor, the foregoing acquires particular importance. As much as it is important in this phase of reflection, it is also important to bear in mind, in the European sphere, the innovations that are precisely arising in this respect.

While informal labor is a reality shared by all the member States of the European Union, it is also true that in some of them the phenomenon continues to increase and places at risk the social security system, the social protection of citizens, affects the labor market and undoubtedly harms competition, without taking into account that it eliminates the criteria of solidarity and social equity that are at the base of the European Union. Already the White Book highlighted the fact that the labor system reform required an in-depth review of the fiscal system in force, so as to include all forms of compensated or partially compensated labor within a common chart comprising the social economy, the provisional work enterprises and the informal economy, with a view to reintegrating to the official labor market a large number of workers that are currently being "left out".

More recently, a Communiqué from the European Commission analyzes the informal labor market, its repercussion, the political problems its poses. The conclusions of the Commission are serious: it states that "undeclared employment significantly contributes to the poor operation of product, services and labor markets. It affects the development of interested individuals, the bases of financing and social protection, since the reduction of revenues leads to the deterioration of the level of services which the State may provide". It also reiterates that any initiative in relation to informal labor must reduce the economic advantages, thus inverting the risk/benefit relationship and that the reintegration of numerous workers that have been left outside the official employment market, represents a challenge to the entire European Union.

In general, it is worthwhile to indicate here some elements for reflection in order to identify the most important causes of the existence and growth of the informal economy and informal labor.

The increase in tax pressure and increase in the weight of social taxes: the basic idea is that the higher the difference between the total cost of labor and the worker's remuneration, the greater the incentive for the worker and employer to enter informality. The difference between the total cost of labor and the net salary depends on the assessment system which, accordingly, acts directly on the determination of the incentives to informal labor;

The intensity and complexity of the normative system: the more complex the assessment system, the less incentives there are for carrying

out informal activities. What could appear as a contradiction derives from the fact that a complex fiscal system strongly facilitates tax avoidance. This reduces the difference between the expected earning, derived from the formal activities for which the tax may be avoided and that derived from the same informal activities;

The characteristics and mechanisms for regulating the labor market: among the most interesting elements to be considered are such regulating elements as the forced reduction of the work schedule. To the extent the work schedule is forcefully reduced and it does not correspond to the expectations of the workers, there is the possibility for an increase of the informal economy, as it occurred in Germany with the work sharing experiment at the Volkswagen facilities. In the same manner, there is a greater possibility for informal work by workers who retire in advance as well as for part-time workers. Similarly, the existence of high levels of unemployment favors the development of legal and illegal informal activities.

THE TAX PRESSURE IN ITALY AND THE DISTORTIONS

From the data maintained by the Organization for Economic Cooperation and Development (OECD) regarding tax pressure, seen as a whole, in the countries that are members thereof, it is evident that in Italy, deductions are high in absolute terms, as well as in relation to the main European and extra-European countries. Assessment of businesses has followed in our country, during the past decades, an evolution only shared in part by the largest industrialized countries and, in particular, by the main countries of the European Union. In general, the trend is framed within a behavior that is of fundamental interest to global tax collection.

If overall data show that in the eighties and nineties there has been a general increase in tax pressure in all the OECD countries, as regards Italy, in a very reduced temporary framework, we have gone from a regime of low tax pressure to one of high tax pressure, contrary to what has occurred in countries such as France, Germany and the United Kingdom.

In the eighties and nineties, "while in the EU and OECD countries there is a decrease, in Italy there is an increasing pace. In particular, between 1985 and 1996, while in most of the European Union and OECD countries the pressure increased between 2% and 3%, and in some important countries

it remained stable (Germany and Japan), or was slightly reduced (United Kingdom), in Italy it increased almost nine points".

The foregoing suggests that the Italian tax system has been exposed in these years to considerable "stress". In addition, it has caused significant effects on the redistribution as well as in the competitive capacity of our productive system in a context of high and increasing interdependence of the economies. The need for a change in taxation has been further stressed, even more so, in the sphere of the European Union, with the downfall of the formal barriers to the circulation of financial capitals and the adoption of a single currency.

Taxation comprises practically unavoidable distortions, which nevertheless may be diminished through timely modifications of the tax structures and the relevance of such distortions cannot but be related to the global value of taxation. In some countries, the reaction to distortions, even those of an "international" origin, has mainly resulted in the induced reduction of taxation of yields from financial activities and of the rates of corporate taxation. Only in some countries (the Scandinavian ones and, more recently, as will be stated further on, Italy), the solution has been sought in a reform of the type of taxation of business results and yields from financial activities.

It is not inappropriate then, at this stage of this research, to argue about the phenomenon of tax evasion in Italy. The latter has acquired an importance that has no comparison within the sphere of the most industrialized countries and it is equally important to recall that evasion is generally analyzed in terms of the decision of the individual who, with the usual logical construction of methodological individualism, compares the benefits of evasion (substantially the tax savings, that will be greater to the extent the rates are higher and, in the case of progressive taxes, the more stressed the progressiveness) with the costs he must incur. In this sphere, it is considered possible to elaborate tax policy measures that may act on the level of evasion with an adequate determination of the rates and sanctions. It does not seem irrelevant to concentrate on the fact that the real social perception of total or partial concealment of the taxable amount as antisocial act could, potentially, modify, in a substantial manner, the cost/benefit relationship in the individual's decision. The evading

taxpayer, that is, in the case of examination, could also attribute a much higher value to the moral cost than the monetary one and thus be induced, in line of principle, to waive concealment of the taxable amount.

The situation of the Italian treasury, in the early nineties, had reached the point of rupture: there was an ever greater dissatisfaction among taxpayers, while the tax administration was faced with a true paralysis situation, by combining manifest inefficiency with frequent episodes of absolute free will.

An excessive number of taxes, an exaggerated amount of taxpayer obligations (almost a hundred, a year, for some categories of taxpayers), a too large number of rates that rendered accounting complex and extremely attractive the opportunities for avoiding and evading the treasury, were added to an exorbitant tax pressure which, especially in the case of company earnings, in some cases above 60%, accompanied by distorted collection and uncertain application on financial earnings, produced as last, but not less important consequence, an examination that penalized the cost of labor.

The tax administration was incapable of effectively combating the evasion phenomena, also due to the frequent “condonations”, the paralyzing effects of an exasperated procedural formalism, the restrictions imposed on human resources management and the general prevalence of a culture of norms and forms that had managed to separate it from the function “of service” to the taxpayers, and negatively interfered with the operation of the entire economic system.

The reforming intervention of the Government in 1998 has been focused on two areas: the reform and reorganization of collection and the reform of procedures and the administration. The process of transformation of the tax system may be substantially seen from the basis of three main requirements to which we have tried to respond:

- The capacity to guarantee the recovery of neutrality of collection with respect to the selection of operators and the use of the productive factors;
- The initiation of fiscal decentralization, in accordance with the need to consolidate the process for clearing public accounts and to manage expenditures and the control of receipts by different levels of government;
- The expansion of the tax base and the simplification of the relationship between the Tax Administration and the taxpayer.

The distorted combination of high nominal, fiscal and contributive rates, with an entrepreneurial order dominated by extreme segmentation of the productive base and resorting as a priority to bank credit, have been the origin of the most relevant economic distortions which companies have ever denounced. These distortions, through the years, have become true limitations to development. For this reason, there has been an elimination of all obligatory forms of sanitary contributions in proportion to compensations, as well as a series of taxes such as Local Income Tax (ILOR), Community Tax on Productive Activities (ICIAP), the rate of concession on Vat and the net worth tax of corporations.

All these charges have been substituted with a new regional tax, the IRAP (Regional Tax on Productive Activities), characterized by a broad tax base (value added, proceeds, normally understood as the difference between the value of production, direct costs and amortizations), and a proportional rate. The adoption of such tax system, which has also resulted in the reduction of the tax rate that encumbers corporations, has also reduced the convenience of adopting behaviors intended to restrict the tax base, through artifices, and to inadequately use the corporate instrument for avoiding taxes.

Even more so, in the attempt to make the election between financial investment and productive investment completely neutral, the *Dual Income Tax* (DIT) has been introduced, which provides for taxing with the same proportional rate, business income, capital income and the income of wage earners belonging to the initial income tax item.

In accordance with the need to create conditions for a reduction of formal rates and simplification of treatment, consideration has also been given to the assessment of financial income. There are three proposed objectives: expansion of the tax base; simplification of the assessment regime, favoring the concentration of examination and collection on financial intermediaries; the neutrality of taxation, overcoming extremely heterogeneous tax systems in relation to the different types of financial income, and reducing the opportunities for tax arbitration operations and elusive behaviors. By applying a proportional tax, in a standard manner to all income in question, separate from personal income tax, neutral assessment is achieved, which no longer lends itself to avoidance or arbitrariness.

No less important are the actions aimed at the number of taxes, excess obligations attributed to citizens and businesses, high formal rates and undesired effects of progressiveness.

Also from this standpoint, the elimination of sanitary contributions and other taxes and the introduction of IRAP are a significant step forward, in terms of obligations as well as controls. On considering these problems, direct consideration has also been given to the simplification of taxpayer obligations, as regards examinations and the sanctions system.

Above all, a management system has been approved, which involves the unification of the income, VAT and social tax returns, the unification of the tax bases for fiscal and social security purposes, with the modalities of unified and simplified payments.

Also introduced, is the juridical figure of compensation between credits and debts, fiscal as well as contributive, which has allowed the total elimination of the credit formation mechanisms, which resulted in exorbitant amounts of refunds, and whose assessment is historically one of the most serious problems, which the financial administration had never been able to resolve.

At the same time, the reform will render more difficult evasion derived from the rather diffused behavior of declaring different amounts to the treasury and to social security. In fact, electronic transmission of returns presupposes preventive control by the individuals authorized to receive such returns, of the result and coherence of data prior to electronic transfer, through the use of software made available by the financial administration.

Before filing the following year's return, the financial administration performs the automatic control of the data declared and payments made, and inform the taxpayer the accounting result, also to avoid the repetition of formal errors by the taxpayer.

The benefits of the new system for the financial administration derive from the drastic reduction in the number of returns and payments (respectively, from 47 million to 22.5 million and from 82 million to 34 million), from the progressive reduction of paper documents, advanced availability of data (that are subsequently integrated to other data transmitted by external organizations and which shall constitute, as of this year, the "country's data bank for examination"),

greater speed in formal control, time reduction in substantial controls and greater examination capacity, with more resources devoted to the activity.

Secondly, by introducing the juridical figures of examination with adherence and judicial conciliation –which modalities, both promptly determine the relationships between the taxpayers and the treasury—an objective has been a strong acceleration of collection, also contributing to the reduction of legal tax disputes.

As of the implementation of the 1973 reform, Italy has followed three processes for facing this problem: one, by increasing the number of individuals obliged to keep accounting records, then by multiplying the “instrumental” obligations and finally by introducing particular instruments, such as presumptive income coefficients, parameters, minimum tax, which endeavored to determine the earnings or presumptive revenues based on data included in the income returns.

These instruments have been difficult to manage, also because economic activities are numerous and it is impossible to reduce them to a few large categories. Besides, within identical activities, there may also be a significant change in the capacity for producing earnings, upon variation of the structural and market elements or territorial location. Thus, parameters obtained on the basis of surveys and dealing with extremely general categories could, in some cases, determine undesired distortions.

The experience of these past years have led the Treasury to adopt measures which, seeking among the resources that the businessman or professional really needs to manage his own activities, may allow for obtaining more satisfactory results, especially in terms of controls. The path followed has been that defined as “sectorial studies”.

These are studies, which, through the individualization of the structural characteristics of each activity, and which have been introduced with the support of the associations, allow for anticipating with an incredible approximation, which are the companies’ operating conditions. The sector studies which accordingly, may also serve as instrument for evaluating the economic efficiency— constitute a modern examination system which may be used for evaluating the

income producing capacity of each of the economic activities that must be subject to assessment. On the other hand, as previously mentioned, the systematic compilation of a series of data, even of not an exclusive fiscal nature, will allow a better classification of the investigated activity and the economic context wherein it is carried out. These render more transparent the criteria adopted by the tax administration for making its examinations, based on objective parameters that are coherent with the economic reality of the territory.

The objectives, which the Italian tax administration thus hopes to achieve, are:

- **A higher transparency and objectivity of its activity,** due to the notoriousness of the criteria used by the administration in its examinations and the reference chart that serves as basis for the examination and inspection activities carried out by the Administration's staff.

  In practice, the taxpayer may adapt his own returns to the indicators shown in the study developed by the Ministry of Finance for his own productive or economic sector or else, he may not do so, if he considers that there are valid and well founded reasons that justify his non-adherence, although in this way he lays sound premises for a tax examination.

- **Stability and coherence** of the economic indicators adopted for the examinations and inspections, inasmuch as the "sectorial studies" systematically updated and fine tuned, are intended to continue as constant reference and because of the circumstance that, even though they reflect the Country's diversified economic reality, they have the same common logical structures;

- **The certainty of the relationships between the Administration and taxpayer**, since the elements of statistical uncertainty are reduced to a minimum, by virtue of the fact that the studies are elaborated with the collaboration of the associations and through the provision of preventive questionnaires to taxpayers belonging to a specific class and not on the basis of a generic survey. By acquiring data relative to a series of operators (economic,

n.d.t.) it will be possible to establish ever more homogeneous groups by territory, by dimension and structural characteristics, that will allow a more in-depth examination of the results of management;

- **A more effective struggle against abusive practices and unfair competition,** because by inducing taxpayers to modify their behaviors, the need to resort to practices that are contrary to the economic rules of the market and which use “fiscal savings” to exercise unfair competition, will be minimized.

The sectorial studies overcome the modality of controlling earnings exclusively on the basis of the examination of accounting documents. Sectorial studies allow for determining earnings that with greater probability may be attributed to the taxpayer, by outlining not only the potential capacity of producing earnings, but also becoming aware of the internal factors (the productive process, the sales area, etc.) and external (fluctuation of the demand, the level of prices, competition, the territorial area where the company operates), the company under examination and may influence the same capacity. Accordingly, these factors will be carefully evaluated by the tax Administration, by also involving the peripheral structures of the same administration and the experts designated by the associations. From the standpoint of the latter, among the multiple objectives attributed to the sectorial studies are those referring to promoting spontaneous voluntary compliance with tax obligations by the taxpayers, with the additional thrust of the use of examination through adhesion which, on the other hand, releases human resources that may be devoted to the development of other and no less profitable activities.

Another essential aspect to be faced is the adaptation of the administration’s organization and the procedures followed, no longer in tax management, but for the restructuring of the taxpayer’s global fiscal position.

With respect to the modification of procedures, it must be noted that, since 1996, the Italian tax administration has introduced, first in public administration (sic, n.d.t.), the strategic management planning, programming and control process. Since then, a General Directive for administrative action and management annually issued by the Ministry of Finance regulates everything.

As regards the Revenue Department, it is anticipated that priority will be given to promote activities against evasion. In such context, increased revenues should be obtained through the adoption of adequate organizational methods, as well as through the expansion of the global effectiveness of the examination activity.

In addition, a strong innovative element was the extended use of electronic transmission of returns and activation of the automated process for controlling them. Such activity, as regards the assessment of taxes, contributions, incentives and refunds within the period for filing returns relative to the following year, must allow for the on-line entry of necessary data in order to make controls more effective from the standpoint of timeliness as well as profitability.

The results of such reforms have already been evident. It is so much so that, in view of the greater revenues received in the year 2000, the Government has proceeded, starting this year, to the review of the Individual Income Tax (IRPEF) rates. In the year 2001, the objective is to recover, from those who failed to pay taxes, around 12 billion Lires, that is, double the amount collected in 2000. These new revenues may obviously guarantee new compensations in favor of the taxpayers.

Another element to which the Government has given great attention, especially in the past period, are the so-called “salary realignment contracts”. Such contracts, in use since 1986 by agreement between the social parties and regulated by public intervention, seek to detect irregular labor. In 1998, by means of a law, the Committee for the detection of irregular labor of the Presidency of the Council of Ministers was established. It also provides for the establishment of regional and provincial Commissions. As has been previously stated, the line of demarcation between regular or emerged and irregular or submerged workers is by nature, subtle and changeable. The pace of the economy and public intervention may push it in either direction. For example, an economic recession usually causes an increase in concealment or immersion of the working activities. In this atmosphere of variability of the limit between regular and irregular, the Committee of the Council’s Presidency has sustained and firmly sustains the thesis of progressive regularization of the activities and occupation.

The realignment contracts are instruments through which companies are allowed the possibility, by means of territorial and entrepreneurial agreements, to settle their situation within a term of three years, obtaining in exchange a substantial decrease in the three-year period (up to 75) of the tax obligations. For the workers, this implies, in the same period, receiving lower salaries than those provided in the collective contracts, obtaining instead an essential contributive position for retirement purposes.

According to data provided by the Ministry of Labor, in December 1999, there were 199 agreements for a total of 22,010 enterprises that have adhered to realignment. On the other hand, in relation to this issue, the Government had to confront the European Commission to overcome its objections as to the fact that in the realignment contracts one may detect the mechanisms of distortion of competition. As a result, there is an important aspect in relation to the benefits for the companies following realignment. That is, it is a matter of verifying if the occupation derived therefrom, may or may not be considered “new occupation” and accordingly maintained, to avoid from going back to informality.

Notwithstanding the lack of official estimations, at a certain point, consideration was given for 1999, to some 15-20 billion (Lires) of fiscal revenues and more than one billion Lires of additional tax revenues. To the foregoing, one must add the evidence, rather interesting, originating from the sectorial studies. In sum, it is clear that the increase of regular labor includes undoubtedly an important component of immersion: only for the so-called INAIL “accountant” (National Institute of Labor Misfortunes) there was talk of 150,000 additional followers. This process of immersion was possible thanks to a series of convergent factors (social, cultural, administrative, civil, economic).

To complete the illustration of the Italian fiscal reform, it must be added that it was structured following the tax orientation that is being affirmed throughout Europe. The European Commission itself has underlined this aspect, which acquires particular importance in this phase, wherein monetary unification excludes every possibility of using changes for inadequate objectives of economic competition. Such circumstance, jointly with the free possibility of transferring capitals from one European country to another, makes the fiscal issue an important aspect when making investment decisions.

For this reason, the Council of economic and financial ministers of the European Union (EconFin Council) has made decisions with a view to excluding situations of fiscal competition and committing every country to initiate the review of particularly advantageous regimes still in force. This is a fundamental option, for balanced development of the economies as well as for guaranteeing the markets conditions of neutrality which only they can offer (sic, n.d.t.).

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Case study:

TOPIC 3.3

STRATEGIES FOR DETECTING AND INCORPORATING THE UNDERGROUND ECONOMY

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"If I would know that the world would end tomorrow,
even today I would plant a tree"
- Martin Luther King -

INTRODUCTION

In every economy, especially those of the so-called third world, there are activities carried out by individuals who, for varied reasons carry them outside the established legal requirements; that is, in an informal manner, thus becoming a marginal sector of the economy whose objective valuation calls for analyzing the structural

conditions that generate them and the characteristics of the process of economic development wherein it is found.

Economic informality in the underdeveloped countries originates in the material inability to resort to legitimate ways of satisfying basic needs and achieving a dignified standard of living, which situation calls, in many cases, for using force to satisfy such needs and rights.

The Colombian economic reality is not removed from the context of developing country, where there is a series of factors that renders difficult economic instruments: high levels of poverty, inequity, low levels of education, concentration of economic and social power, and the limited capability of state management.

Informality is a term used to refer to a trend that is characteristic of certain types of productive and commercial activities of the industrial, manufacturing and crafts sectors (spare parts produced for automobiles, electrical appliances, computers, agricultural input materials; raw materials for the manufacturing of clothes, bags and shoes, ...; sale of furniture and all types of elements of lumber industry such as the production of parts, production of furniture and wood elements, etc.) that arise as a way for overcoming the low levels of productivity and the precarious conditions wherein many individuals and businesses are forced to carry out their productive and commercial activity, which separates them from the fundamental working standards and prevent them from achieving a minimum dignified living standard. Such companies are small businesses with a low profitability that reaches levels of up to 50% in various economic sectors.

For the greater part of the population there is then only one possibility of income: that of informality, that of the subsistence economy. There arises thus the trend of some individuals that, given the urgency to generate a level of income to respond to a high level of needs, resort to informality, thus being able to handle not only a high flexibility in time, and specialty of the economic activity, but also marketing their products at lower prices than those handled by the formal business.

In general terms, it may be said that in Colombia, the underground economy comprises those economic activities which, since they are found in an action scenario unrelated to compliance with formal

obligations, the volumes of transactions handled, the low costs of production and the fluctuation of prices they may offer the public, they end up altering the regular process of the formal and organized market, thus becoming for the latter a factor of unfair competition.

FACTORS FAVORING THE DEVELOPMENT OF THE UNDERGROUND BUSINESS IN COLOMBIA

Since the Government is interested in formalizing such activities and individuals, it has been working in the design and execution of some strategies that may allow it to locate such individuals, as well as some mechanisms that may stimulate and render viable their incorporation to the country's economic policy, since many of them, show high volumes of transactions which are frequently promoted by the very economic behavior.

I will now describe in detail the factors that favor the development of the underground economic activity, each of which implies a large number of interrelationships, in such a way that many of them, are influenced by others that strengthen them or have a direct repercussion on the other factors.

1. High Tax Burdens:

- ✓ 35% on the cleared *net income* obtained from the taxpayer in the respective fiscal period.
- ✓ A rate of 20% for taxpayers with special treatment such as nonprofit entities devoted to educational, sports, cultural and scientific and technological research activities.
- ✓ *Exemptions* in sectors such as the editorial industry, public services in a gradual manner, and free zones, etc.
- ✓ 16% tax on sales, starting on January 2001, with differential rates: 20% for certain types of vehicles, 35% for articles considered luxurious, 10% for air trip tickets and some basic food products such as oils and fats.
- ✓ *VAT* collected through the *Withholding at the Source* mechanism provided there is an operation involving the sale of products or the sale of services between someone responsible authorized to make the withholding and any person of the common Regime.

- ✓ *VAT Withholding at the Source System,* for the case of those responsible for the "simplified system", with a high cost for whoever negotiates with this type of taxpayers since, even though theoretically the mechanism may exist, whoever pays to the one responsible assumes 75% of the value of the VAT rate to be paid to the State, with which the cash flow of these taxpayers may be affected or ensure that the suppliers registered under such regime formalize themselves under the general scheme of the common regime.

2. Excessive Formal Obligations:

The person trying to set up business in Colombia must fulfill the following formal obligations vis-à-vis the tax administration, which must be complied if he subjects himself to the Colombian commercial regulation, according to the national, departmental or municipal sphere wherein its activity is carried out:

Annual income and complementary tax return.
- ✓ Bimonthly VAT return (6 per year).
- ✓ Monthly withholding at the source returns (12 per year).
- ✓ Annual land tax return for every plot of land owned.
- ✓ Bimonthly return of industry and commerce, notices and billboards, to the District or Municipality (6 per year).
- ✓ Annual return of vehicle tax, for every car owned.

To the foregoing obligations, others are added such as that provided in the Colombian Tax Statute of annually informing, either through mechanical or magnetic means, the current status of the net worth or income conditions of the taxpayer and of providing the information required by the surveillance and economic control organizations such as the Bank, Corporations Securities Superintendencies, and the Ministry of the Environment.

3. Labor and parafiscal obligations:

In Colombia, employers are obliged to register their workers in the social security regime, by assuming two thirds of the affiliation fee and monthly contribution and without disregarding the option they have of choosing the promoting entity. Likewise,

it is necessary to contribute to the Pension Funds, which the worker may also have chosen, with payment of the rate corresponding to the employer.

4. Obligations to register:

- ✓ Register the business in the Chamber of Commerce corresponding to the site or domicile where the economic activity is carried out with payment of the corresponding registration tax, according to the net worth of the business or establishment.
- ✓ Register the accounting records of the taxpayer and any modification or addition made to the articles of incorporation.

5. Credit Restrictions (leasing, factoring, etc.)***:***

In Colombia, every person has access to credit, but the formally constituted company (micro, medium or small) has greater facilities for obtaining credits to promote installation and technological assistance for setting up the business or to export, while whoever is in the underground economy, credit options and possibilities for obtaining governmental assistance are reduced to a great extent.

6. Export and import procedures:

Refers to the legal constitution as well as to the authorization for undertaking foreign trade activities and before the DIAN.

7. Deficient Infrastructure

Those wishing to establish regular businesses that call for stratification within the commercial, industrial, manufacturing or service sectors require a high level of revenues that may allow them to cover the increase in the service rates and in operation expenses resulting from the process of stratification.

8. Economic Policy:

There is a lack of political will to handle special tax treatment schemes with greater incentives and simplification of obligations that may allow the incorporation of this type of taxpayers to the country's tax process.

9. Legal Requirements:

The rules governing businesses in relation to compliance with contracts, property rights, brands, patents and standards show a marked tendency toward diversity and in turn, becoming a favorable factor for nonplanning, disorganization and insecurity vis-à-vis public administration.

10. Culture:

The concept of State and traditional development in Colombia have generated a wide index of administrative corruption and opposition to change among leaders, which leads them to establish all kinds of obstacles to the regulation of underground activities, by means of permanent questioning of the use to be made of taxes to which they may be subjected.

11. Operation of the State:

The Colombian contractual scheme provides for excessive procedures for businessmen wishing to undertake some interaction with the State, with demands that cannot be complied with even through formalization and which render the latter an unattractive option. This is so, especially with small and medium producers and businessmen, which are thus prone to resort to informality and those behaviors that affect the harmonious and legal development of society such as: contraband, invasion of public space and insecurity.

Of this group of social calamities, contraband is one of the informal behaviors in Colombia with the highest index of action, which has been directly attacked by the National Government and the DIAN, in some cases with the cooperation of international organizations and firms interested in continuing to operate in Colombia on a regular basis and with guarantees for their products.

STATE PERSPECTIVES

To regulate underground commercial activities, the State must design and implement a strategy that may take into account the following aspects:

1. The availability of some economic instruments whose main objective will not be the generation of additional financing for the State, but rather that, at a reasonable cost, it may be aimed at the change of behavior of informal businessmen.

2. Differentiation of economic instruments, as to whether they affect or not all of the formal or informal businessmen (taxes on input) or if they only have an effect on the formal ones (tax exemption).

3. Underground activities cover a series of circumstances as those mentioned below and which, on coinciding on a single and same problem, are the main cause of resistance to change that characterizes those who carry out this type of activities:

   A. The activity that they carry out is mainly of a crafts nature.
   B. The size of the business, the volume of activities and the number of its employees is very small.
   C. Production and commercialization processes are carried out to a great extent with the participation of the family group.
   D. Empirical formation in some sectors, for lack of training centers at all levels and areas of the economy.
   E. The difficulty of owners and employees to have access to higher education.
   F. The lack of capital and insufficiency of human resources in the administrative and organizational areas.
   G. Business activity centered on production, services or sales, and disregarding the need for administrative organization.
   H. The trade performed includes a high manual or empirical content. This is at the same time the greatest virtue of many of these types of trades.
   I. The low levels of technological infrastructure for production and registration of commercial operations and resistance to operate in a manner other than the informal one.
   J. The high economic costs requiring accounting and administrative organization and tax implementation.

STRUCTURE OF THE UNDERGROUND BUSINESS

To the aforementioned circumstances one may add the deficiencies in their administrative and organizational structures, namely:

- ✓ In most cases, they count on a general manager and chief of production, whose work is reinforced at times, with an administrative adviser, an accountant, a few salesmen and some plant operators and all of them with an overload of functions.
- ✓ There is an inefficient managerial authority and no adequate control mechanisms.
- ✓ There is no consciousness with respect to compliance with tax obligations.
- ✓ There is no functions and procedures manual.
- ✓ There is reluctance to comply with legal formalities and parafiscal, beneficial, tax and commercial registration obligations.
- ✓ Many businesses are unipersonal or under the figure of temporary association, for which reason they maintain a tradition with respect to daily activities, with an unfavorable attitude toward voluntary change, unless they are offered incentives and easily perceptible economic and fiscal benefits.
- ✓ The greater part of those carrying out this type of activities are individuals whose cultural biases prevent them from locating themselves within formality or groups of individuals who attempt to organize themselves in corporations and cannot manage to do so, or organize themselves as private corporations without any type of notarial formalization or registry before the Chamber of Commerce.

STATE'S ACTION AND MEASURES ADOPTED

The emphasis of governmental entities for reducing the levels of evasion and noncompliance with tax obligations must be placed on assisting the participants and scenarios of underground activity as regards the simplification of tax obligations, payments and returns, the reduction of administrative costs, the creation of an adequate infrastructure which may be as centralized as possible, as well as the expansion, training and assistance in relation to tax information; which purposes could be fully achieved, provided they go hand in

hand with the progressive development of: specific determination of economic sectors affected by informality (1); the identification of individuals and business prone to informality (2) and the classification of the type of individuals and businesses located within such trend.

MEANS FOR LOCATING AND IDENTIFYING UNDERGROUND COMMERCIAL ACTIVITIES

In Colombia, underground businesses have been located through different means, namely:

- ✓ Information on magnetic media from taxpaying and non-taxpaying individuals or entities, for the purpose of undertaking investigations and information crosschecks for an adequate control of taxes in relation to suppliers reported by large taxpayers and corporations in general, payments or on account payments consisting of tax revenues of third parties by way of acquisition of goods or services, payments that constitute cost or deduction or allow for tax deductions or tax discounts, including the acquisition of fixed or movable assets and the direct verification of the existence of the underground businesses, by means of visits, surveys and permanent census.

  In relation to this strategy, it is worth noting that in order to achieve formalization of the greater part of businesses not registered in the tax administration, in 1999,.the DIAN of Colombia undertook a program of 50.000 surveys-census in the different cities of the country under the area framework modality and list framework, aimed at different economic sectors of the country, whereby it was possible to determine the cities with economic sectors with a tendency toward informality.

  The area framework modality allows the visit to all businesses of each of the predetermined geographical sectors, with a view to locating the nonfiling or nonregistered businesses and taxpayers. On the other hand, the list modality allowed for visits to taxpayers registered in the simplified Regime, as well as to determine the composition, structure and economic levels that would show compliance with the

conditions for continuing in the simplification Regime or passing to the new Regime that was subsequently provided in the law under the name of Single Taxation Regime (STR). For reasons of interpretation by our country's Honorable Constitutional Court, the regime created through Law 488 of 1998, as a scheme for simplifying tax obligations and with a high social content that endeavored to incorporate the underground businesses, avoid them numberless formal obligations and the high costs resulting from State obligations and which even today prevent the regularization of businesses – was declared unattainable and withdrawn from the national juridical code.

- ✓ Direct examination of taxpayers that are registered in the simplified sales tax Regime and who do not comply with the conditions for being there, thus generating informality and unfair business competition:

  The Colombian legal structure has allowed many taxpayers to shield themselves by registering in the simplified Regime modality to avoid compliance with tax obligations, thus also generating unfair competition, since, under such regime, taxpayers or entities responsible do not charge VAT, do not issue invoices, do not file sales tax return; as a general rule, they do not file income and complementary tax return either and most of them do not have withholding agents. Therefore, this regime seems very attractive and quite interesting for the citizen, since, without being subjected to formal obligations, he counts on the law's protection when registering thereunder. This structure has resulted in the analysis of many legal forms for registering taxpayers under the common Regime, but, above all, for generating new schemes which, according to international experience in the handling of VAT, have shown some importance in the implementation of new forms of facilitation for these small taxpayers and in achieving their formalization.

ACHIEVEMENTS IN PROCESSES FOR THE NORMAL INCORPORATION OF UNDERGROUND BUSINESSES IN COLOMBIA

It is fair to say that in Colombia, tax schemes for the benefit of small and underground businesses have been attempted, but given their legal structure, the bills are submitted to discussion at the Congress of the Republic, where a legal procedure may take a semester and even much more, in most cases. The government lacks broad powers to design facilitation schemes for this type of business and therefore, they must necessarily be subjected to previous analysis by Congress, to end up with a Law of the Republic, whose attainability must be examined by the Honorable Constitutional Court and following request from the citizen, which may generate some type of juridical insecurity and in many cases, the loss of resources that are devoted to achieve an end, but arrive at no conclusion or whose result may not coincide therewith.

In spite of the aforementioned situation in Colombia, some level of formalization of small and medium businesses has been achieved as a result of the Programs for the Verification of Nonregistered through the aforementioned means. It must nevertheless be admitted that there have been expressions of nonconformity by those involved, as a result of the economic crisis affecting the country, which results in very high costs of compliance for this type of businesses.

These achievements have also been possible through the approach and sectorial counseling on the current fiscal scheme and the obligations it implies, direct and personalized attention in some tax Administrations, the elaboration of pamphlets and guides indicating minimum obligations to be fulfilled, the installation of the call-center in some administrations for promptly and efficiently answering the doubts of businessmen and those interested in joining the fiscal world and advertising programs aimed at such type of responsible individuals, especially through massive media such as radio and television.

BENEFITS PROVIDED IN THE NEW TAX REGIME

The recent tax reform provided in Law 633 of December 29, 2000 included under the Simplified Regime only those businesses that were really small and are outside the control of the State and lack minimum conditions for guaranteeing compliance with all the obligations required of those registered under the common Regime, given the low volume of their operations and fragility of their structure. Thus, the law endeavors that the informal individuals, under the parameters provided therein, may at least be registered before the Tax Administration and fulfill the minimum obligations stipulated therein. For this reason, it has been determined that the Simplified Regime may include individuals performing as retail businessmen, selling taxed products or rendering taxed services, whose income in the immediately preceding year (2000) would be less than $ 42.000.000, and who do not have more than one commercial establishment or headquarters, office, or business.

Likewise, the new law has stipulated a mechanism for detecting taxpayers through the figure of presumption of law, which is based on the assumption that the operation of any business involves some costs that, in one way or another, reflect certain capacity in obtaining revenues, for defraying and sustaining them, or for preserving a minimum of profit that may allow them to continue in the market.

Thus, in the case of the individual whose radius of commercial action is framed within informality or within the simplified regime, but whose economic analysis determines that in the immediately preceding year, he had eight or more workers, would have paid more that 35 minimum legal salaries in force by way of lease of premises, headquarters, business, office or establishment, that would have devoted more than twenty monthly legal minimum salaries in force by way of public services, or would have made deposits in current or savings bank accounts exceeding $70.000.000 (year 2000) will automatically be reclassified in the common regime.

In this way, the Colombian government as well as the DIAN expect that through exogenous information and field work it will be possible to incorporate to the fiscal world an adequate number of citizens devoted to businesses, but which up till now are outside the control of the State. Also, seminars will be carried out for providing training,

counseling and assistance to the taxpayers, in order that they may be familiar with the law and so that they may spontaneously and conscientiously register in the regime wherein their productive or commercial activity is found and they may thus comply with their corresponding obligations.

BY WAY OF CONCLUSION

The significant efforts which must be undertaken by the State to detect and direct the participants in the underground economy involve high costs for the Tax Administration, considering that in order to control these taxpayers, it must perform important information crosschecks, examination efforts and incur in administrative costs as well.

In this control, the Tax Administration ends up facing a dilemma between the efficiency and simplicity which is being claimed from the State on the one hand, and the preservation of the principle of equity, on the other. In practice, simplified regimes involves significant obstacles for control; first, because the large number of taxpayers comprising it, tend to be atomized and dispersed and, second, because the cost of examination is quite high, with respect to the management potential.

These taxpayers become a fertilized field for tax evasion, a circumstance wherein the benefits resulting from administrative simplicity are overridden by the costs generated through the inequity of fraud.

In view of this situation, which is detrimental, above all, to the principle of equity indicated and as timely response to the high level of effectiveness in the control of the informal sector by involving the participation of the private sector, the tax administrations use mechanisms with a high level of simplicity. Within these measures, we may consider the generalization of mechanisms of withholding at the source and withholding of the sales tax for individuals belonging to the simplified regime.

Taxpayers registered in the aforementioned simplified regime normally make little or no tax contribution which, on the other hand, promote the culture of “no contribution” with all the implications

which this paradigm may entail in the structuring of a social, sound, cohesive tissue with the sense of identity. For this reason, any modern tax administration should count on unified taxation schemes such as the Single Taxation Regime that unfortunately was declared unattainable in our country or the substitutive taxation regimes.

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TOPIC 4

THE CONTROL OF INTERNATIONAL OPERATIONS

Lecture

TOPIC 4

THE CONTROL OF INTERNATIONAL OPERATIONS

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CONTENTS: The control of international operations.- Globalization.- Trends.- Present situation.- International cooperation.- International tax cooperation activities.- Summary.

Abstract

The control of international operations

Globalization is increasing the significance of international operations from a tax standpoint. This extends to transfer pricing, customs valuation, tax havens/fiscal secrecy and includes consideration of the impact of digitalization.

This session is a conceptual analysis of the present situation with a view towards its impact on tax administration.

GLOBALIZATION

- Number of Stock Markets has doubled in 90's.
- Foreign Direct Investment $50 B in 1985; $800 B in 1999.
- Currently one-fifth of the World Output is subject to free trade; in 30 years –this share will grow to four-fifths.

- International travel a prime indicator of globalization; by 2020, estimated that .6 B of 7.8 B Population Intl Travel.
- Globalization is not new, existed at the Turn of the Century.
- World Wars introduced National borders, Trade Barriers, and travel restrictions.
- Markets began opening in the 1980's - Opening greatly accelerated by Technology explosion.

TRENDS

Global Environment:

- Globalization will be the driver which underscores the need for cooperation
- The tool of globalization is electronic commerce; providing both challenges and opportunities.
- The trend for strong cost efficiency in tax administration will continue while the amount of work increases
- We will need to take cooperative steps between countries to be successful

Government Service:

- Service delivery will continue to be driven and shaped by citizen's expectations and requests. There will be a continuing strong expectation of value for money (in return for paying taxes, expect the best products and services)
- Alternative service mechanisms will be increasingly required. The trend to contract management to outsource the non-core businesses will increase
- Trend to seamless service across Government and levels of Government with decreasing contact points will continue —e.g., one-stop shopping and E-Government
- The shift in demand to electronic services will strengthen. Even where personal contact chosen there will be a strong preference for anonymity.

Compliance:

- Service and compliance will no longer be distinct strategies but part of a continuum

- Compliance strategy will increasingly emphasize good corporate citizenship and making taxpayers aware of their social and fiscal contribution. Increasingly service will be regarded as the lever for creating a positive community attitude to paying tax making the link between paying tax and being a good citizen
- There will be an increasing emphasis on researching and understanding the complexities of taxpayer behaviour and their responses to Government. This will lead to designing tailored strategies to encourage positive behaviour.
- Trend to earlier intervention to combat mass marketed schemes will continue. Pushback against compliance activity focussed on aggressive planning becoming increasingly aggressive (e.g., liens on promoters)
- Drive by Multinationals to minimize their tax burden worldwide will continue.

PRESENT SITUATION

For the IRS, for more than 30 years one of the ways we classified taxation was to split it as to “Domestic” versus “International”. At the beginning of this period the “International” area of emphasis was the exception to the rule; substantially all dealings with U.S. taxpayers were relative to “Domestic”. “International” as a separate area was created because of the complexity of the law and the feeling that one examiner could not be responsible for technically understanding both areas. Also, while an exception, taxpayers international transactions were viewed as significant because while the number of international transactions were small, the dollar value was not. In the 1970’s we created a specialty position referred to as an International Examiner to address this situation. This position received special training and emphasis. (At this time, we also created other relatively small programs having to do with International Organizations such as CIAT and the OECD).

The process of having Domestic examiners in charge of the audits and utilizing International Examiners as specialists on an “as needed” basis worked well during the 80’s and 90’s. The International Examiner program continued to grow during this time as did our programs devoted to International Operations and Exchange of Information. But they remained the “exception to the rule”. Domestic considerations remained paramount.

But with the advent of E-Commerce in the mid-1990's, the Globalization begun in the 80's has been greatly accelerated. We are now in a situation where "International" as an exception to the rule or as an area of limited application, no holds true. The need for awareness of the International area is becoming the rule not the exception.

- For Large Companies, their foreign transactions and operations are now of equal or greater importance to their success then are their domestic transactions and operations.
- For Small and Medium Enterprises they are increasingly part of the World Economy. The reason for this is simple, the Internet. As soon as a company takes advantage of the Internet, they have in fact gone "Global". There is not such a thing as a "Domestic" Internet. If you are on the Internet, you are Global; if a small concern is doing business over the Internet, they are part of the world economy.

Globalization has also manifested itself for the IRS in combination with our ongoing Modernization efforts. One of the primary principles of this effort is that we should attempt to approach our duties from the Customer's point of view. When examining this issue, we are realizing that increasingly the Taxpayer point of view is "Global".

This influences numerous issues but for our compliance activities, it means having personnel with skills matching those of our Customer, the Global Taxpayer. We need to have Examiners that are globally aware and trained in the domestic and international provisions of our tax laws. There is resistance to this change as our employees are comfortable with the present structure. However, in our discussions with Taxpayers we are realizing that a transition is inevitable and waiting any longer to change is not acceptable.

Some of the steps we our taking to position ourselves to deal with Globalization include:

1. Training
2. Development of new personnel positions
3. Making Globalization one of our Strategic Initiatives

Training:

- We have begun providing our non-International personnel with training relative to the International provisions of our tax law. We recently concluded an interactive video session of courses with more planned for the future. We are building International awareness in to our basic Revenue Agent training.
- We have had the Executives of the LMSB Division attend a two-day session on Globalization at a U.S. Business school located in Atlanta. We have another Globalization session for our Executives planned at a different Business school.
- However, we are not forgetting that the area of International remains a complex area in need of specialists. In this regard we are considering having our International Examiners further specialize by Industry, e.g., Financial Services, Natural Resources, Communication and Technology, etc.

New Management Position:

- Presently the Team Manager in charge of our large examinations is responsible for coordinating the entire team of examiners. However, the international aspects of the case are the responsibility of an International Manager who assigns and manages the International Examiners. Frequently, therefore, when the Taxpayer wants to discuss an International aspect of its audit, the Team Manager refers the Taxpayer to the Manager of the International Specialists.
- This is not the situation with a Global Taxpayer. The Tax Director of a large company knows whatever is important to the Company whether its Domestic or International and increasingly Tax Directors of large companies have extensible international experience.
- Consistent with our Modernization principle of understanding the Taxpayers point of view, we are in the process of developing a Global Team Manager position. This is an attempt to match our skills with those of the taxpayer and would require that the person holding this position be as able to manage an International tax issue as a domestic one. This will take us some time, as it will require revising a structure in place for over 30 years.

- This will be a first step. Not just the Manager needs to be Globally aware.

Globalization Strategic Initiative

The LMSB Division of the IRS has five strategic initiatives; Globalization is one of the five.

Why Globalization as a Strategic Initiative?

- New Ways of Doing Business in a New Economy.
- Characterized by Income from Intellectual Capital and Services.
- Value Creation (Marketing, Manufacturing, and R&D Intangibles).

Some of the aspects of this initiative are:

- Enhance Customer Service/Compliance: Develop Issue Management Strategies including resolving domestic and international issues before the return is filed. Identify the new risks associated with globalization for example, E-commerce and the increasing movement of intangibles offshore.

- Increase Internal Capabilities: Expand Globalization and International training for employees. Enhance Employee understanding of E-Commerce including providing examiners with Internet access and training on how to utilize the Internet.

- Design Organizational Structure: make everyone responsible at least in part, for something concerning International.

- Build Strategic Alliances: Build effective relationships with other Countries. Actively participate in International Organizations. Increasingly engage the Practitioner community. Further develop positive relationships with other U.S. Government Agencies. Work closely with Taxpayers.

INTERNATIONAL COOPERATION

The foregoing discussion highlights some activities the IRS is taking unilaterally to deal with the International impact of Globalization. However, most of us realize the real success will be bilateral or multilateral activities. I believe those of us who have had the pleasure to be involved with the International area, have known for some time the importance and inevitability of International Cooperation to the success of future Tax Administration.

Having Personnel who are Globally aware will heighten a Tax Administration's realization of the need for International Cooperation. Greater portions of our respective agencies are realizing that the "Information" we need to do our jobs is increasingly not within our borders. As the International transactions and operations of our taxpayers increase, so will our need for information beyond our reach. As E-Commerce grows, so will our need for gathering information that is no longer geographically based anywhere.

I believe many countries like the U.S. have legislation requiring taxpayers to provide foreign-based information that is relevant to their tax liability. Most tax administrators realize this will be increasingly insufficient. The awareness of the need for International Cooperation grows.

Generally, the exchange of information provisions of tax conventions and agreements are thought of in this regard. But before discussing Taxpayer specific information, I would like to discuss the expansion of international discussions on issues that are not Taxpayer specific. As an example, the tax work of the OECD has historically been about its Model Tax Convention; getting member countries to agree on the meaning of terms such as royalty, dividend, permanent establishment, etc. Issues of tax administration were generally limited to implementation of treaty-based exchange of information programs. While work on these areas has not changed, the trend in the OECD has been towards an increasingly broader discussion of tax administration.

The perceived need for this expansion of issues is very different. The need for discussing the meaning of a technical term in a treaty such as royalty can be understood as it facilitates trade in that a definition shared by several countries of a cross border transaction

minimizes the chance of double taxation. Now however, within the OECD, discussions have been expanded well beyond the OECD Model Convention to issues such as risk assessments, electronic filing, e-commerce compliance, etc.

This raises some different issues. The reasons for a globally-shared definition of the term royalty are readily understandable by taxpayers and legislators. However, the best way to collect taxes, or to facilitate electronic filing, or provide taxpayer service is not about consensus. Generally, the concept of 'Best Practice" does not always apply when dealing with issues of tax administration; "world class initiative" is frequently the better phrase. Additionally, and equally important, the need for international cooperation on issues of tax administration is not always readily understood by Taxpayers and Legislators.

In contrast to the OECD, work within the CIAT countries has generally focused on issues of tax administration as opposed to defining technical terms. This however, also seems to be changing. More CIAT countries are discussing and entering tax conventions/agreements. Last month there was a meeting in Panama to further the work on a CIAT Model Exchange of Information Agreement.

The direction of CIAT and OECD appear to be towards the same realization. Tax Administrations must cooperate Internationally on a broad basis. To facilitate trade, we need to come to agreement on tax definitions impacting cross border transactions. To be fair in our compliance activities, we need to exchange tax information with other administrations. To provide the best taxpayer service, we need to share information on how best to leverage the Internet and electronic commerce.

INTERNATIONAL TAX COOPERATION ACTIVITIES

What are some of the current activities regarding International Tax Cooperation? (Being from the IRS, my comments are limited to the area of direct taxation; I am certain there are significant similar activities with regard to Customs and Consumption taxes). There are three aspects I would like to touch upon:

1. International Organizations
2. Areas of Cooperation
3. Methods of cooperating

- *International Organizations*

  We have CIAT, OECD, CREDAF, CATA, COTA, IOTA and SGATAR. The basis for these organizations varies. Some of the organizations are based on geographical region, some on economy, and some on language. The number of organizations and the volume of their activities have substantially increased in the last few years. The upcoming meeting on E-Commerce in Montreal in June is an illustration of just how far we have progressed. The June meeting, generously hosted by Canada, involves CIAT, CATA, CREDAF, IOTA, and the OECD. It will involve over 100 countries and the subject of E-Commerce is one epitomizing the need for cooperation.

- *Areas of International Cooperation*

  The areas of tax administration under discussion are too numerous to list. But to illustrate the levels of activity, I will use the area of Electronic Commerce to demonstrate the degree of international cooperation taking place and how it appears to be evolving.

  The OECD with the participation of CIAT countries and through BIAC, business representatives, has completed an initial process involving Technical Advisory Groups (TAG's) who looked at both Technical and Administrative aspects of E-Commerce.

  The work of the TAG's included technical tax law issues such as income characterization and business profits, consumption taxes, and auditing in an Internet environment. The results of these efforts have been generally acknowledged as very successful. The Income Characterization TAG reached consensus on how nearly 30 types of e-commerce income should be characterized for treaty purposes.

  Equally noteworthy is an effort made on a significantly different area of E-Commerce. A group of countries within the OECD have worked together to prepare a submission to the Governmental Advisory Council of ICANN. In short, this concerns the identification information a registrant has to provide in securing a web site. Two countries, including the

U.S., conducted limited studies of e-commerce businesses. Both found that for approximately 15 percent E-Commerce businesses audited, the identity of the owner of the business could not be identified. The countries worked together to draft a mutually agreeable paper, which was presented to the Governmental Advisory Council last week in Melbourne, Australia. The discussion and debate as to the need for the paper and its content was at times emotional and heated. But it was accomplished. I do not recall Tax Administration's cooperating in this manner previously.

For the IRS, this has had an additional positive result. In addressing E-Commerce issues there had not been a great deal of inter-agency cooperation within the U.S. Government. When other U.S. Government agencies heard of the proposed OECD tax submission to ICANN they expressed their shared concerns over the issue of Internet identification. While their missions are different from the IRS, e.g., consumer fraud (Federal Trade Commission), investor fraud (Securities and Exchange Commission) and patent infringement (Patent and Trademark Office), they share the need for accurate Internet identification. As a result of our soliciting the input of the other Agencies to the OECD process, an inter-agency task force is being established to jointly consider this issue. Again, this occurred because of IRS international tax cooperation.

The last description of an area of international cooperation concerns Electronic Filing. E-filing and Taxpayer Service were not high priority areas for Business and were therefore not covered by a TAG. However, they were felt a priority by the Tax Administrators. For this reason last year in Copenhagen, there was a special ad hoc meeting of tax officials having responsibility for e-filing. Fifteen countries attended the two-day session. Issues discussed included digital certificates, credit card payments, web sites, working with outside contractors, etc. The participants felt the session extremely useful. The Copenhagen meeting brought out the point that there are numerous approaches to e-filing and all can be correct. Resources, legislative authority, public support are but three of many considerations which make a specific approach to a tax administration issue correct for a one country but unsuitable for another.

Methods of cooperating.

The methods by which we cooperate are growing. Historically, there were three means by which we communicated: written correspondence, the telephone, and face-to-face meetings. The two major additions are video conferencing and the Internet—including both e-mail and web sites.

Video conferencing seems to work best if there are only two parties involved and the languages of the countries are the same. As for the Internet, the potential use of this medium can not be overestimated particularly with the use of encryption. The security of encryption will enable us to fully utilize the Internet to exchange all information including taxpayer information.

The Internet also promises to be of great value relative to all of our present treaty exchange programs. Here I am referring to Specific, Automatic, and Spontaneous exchanges of information. I will not describe these program areas as I'm fairly certain most participants to this Assembly are familiar with them.

SUMMARY

I've mentioned the arrival of Globalization and some related trends in tax administration; some of the unilateral actions the IRS are taking in addressing Globalization; and lastly, some of the ways in which International Cooperation is expanding. I've also mentioned that with Globalization, tax administrations have no choice but to cooperate internationally.

However, this discussion of International Cooperation would not be complete without mention of one other issue. As we know, the exchange of tax information with tax authorities in other countries is allowed ultimately, because our taxpayers trust us. They trust us when we advise we need the ability to exchange information if we are to be able to administer taxes in a Global Economy in a fair manner.

The advent of Globalization with its tool of E-Commerce provides incredible opportunities for us to share the information we need to be able to collect taxes in a Global Market. But this sharing has restrictions and must be carefully carried out. Exchange of

information combined with E-Commerce technology also provides us with many opportunities to do the wrong thing. I know most of the IRS examiners would love to communicate directly with counterparts in other countries; and the Internet makes this very possible. But I also know most U.S. taxpayers are concerned about this potential ability and have a visceral reaction to its very mention.

As frequently stated, Globalization and E-Commerce provide challenges and opportunities. Globalization requires we increase our level of international cooperation if we are to effectively administer our tax systems. E-Commerce provides us with the ability to accomplish this task. However, we must keep in mind that when we cooperate internationally we must be careful to do so in a manner that maintains our Taxpayers trust in us.

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Case study:

TOPIC 4.1

CONTROLLING THE VALUE OF INTERNATIONAL TRANSACTIONS (CUSTOMS VALUATION AND TRANSFER PRICES)

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CONTENTS: 1. Important Challenges that Generate the Strong Mobilization of Tax Administrations.- A. Important Challenges.- B. The necessary mobilization of administrations.- 2. But Transfer Price Controls Face Difficulties that Lead them to Give Greater Priority to Preventive Solutions.- A. Difficult examination.- B. From there a preventive focus.

Chile's natural heritage has in its center one of the most wonderful and unusual places in the planet: Easter Island. Said Island has among its countless characteristics a peculiarity that, maybe has not called our attention up until now. It is highly likely that it is one of the few places in the world that has not been affected by the price transfer prices. However, we must recognize that minus this exception, the price transfer issue is certainly a global problem.

Among the multinational groups, the assignment of assets to each of the group's distribution entities, the invoicing of services rendered in accounting issues, management or logistics and even the assignment of brands or patents generate more occasions to proceed to the transfer of profits among the different group entities. Therefore, the transfer of taxable liquid from one territory to another, from one State to another.

For tax administrations, the control of these prices allows them to make sure that the taxable liquid from these establishments installed in the national territory reflects an economic reality, that the value added produced in a national territory is effectively encumbered in said national territory. For companies the establishment of a transfer price policy consists in attempting to value each function assumed by the different entities of the group.

The principle commonly admitted is simple: for a company, the price of an assigned asset or a benefit for services rendered to a foreign company that is operating under its dependency or that is under its control must be equal to the “normal” price, that is the price that has been practiced among each other two entities independent between themselves. The “arm’s length principle” is the basic principal of transfer prices.

However, the application of this apparently simple principle reveals to be tremendously complex, for the administrations in charge of controlling its compliance as well as from the companies that must apply it.

It is not the case of surrendering before difficulties: altered invoicing in a multinational group may allow this group to place its profits in the country of its convenience. Given the heterogeneity of the taxation groups among our countries – without talking about tax havens – there could be very strong temptation. Tax administration should defend one of its essential missions: to measure with the greatest precision possible the true paying capacity of its taxpayers.

Due to the ever-growing importance of the economic flows between entities belonging to the same group, transfer prices represent a challenge that justifies the strong mobilization of the tax administrations. Due the complexity of the matter, it generates difficulties that lead tax administrations to give priority to preventive solutions.

1. IMPORTANT CHALLENGES THAT GENERATES THE STRONG MOBILIZATION OF TAX ADMINISTRATIONS

Transfer prices represent a considerable budgetary challenge for the States. This challenge is at the level of the affected flows. In fact, it is in general considered that 60% of the world trade in goods and assets is the object of intra-group exchanges. On the other hand, these “internal” transnational flows are highly concentrated. Due to these two reasons, said challenges make necessary the mobilization of tax administrations.

A. Important Challenges

At the same time these challenges are due to the globalization of the economy and the fragmentation of the functions assumed by companies.

The globalization of the economy is characterized, for the topic that we are covering, by financial globalization, the explosion of international trade and the appearance of e-commerce.

First, financial activities. The general movement of mergers and acquisitions that characterizes the financial activities of the past ten years has not ceased to call their attention. At the end of these operations, some groups within the economic world landscape stand out from the international scope by each activity sector. This concentration of capital in the hands of few groups leads to the integration of all production and sale functions within the same groups, multiplying in this manner the risk that these economic groups may decide to place their profits in places where there is the least possible tax pressure, through the manipulation of internal price assignment.

The explosion of world trade is the second most intense factor of the challenges related to transfer prices. Now, this explosion has to do with factors that, undoubtedly, have not ceased to have effects. We shall now mention two of them.

First, the reduction or progressive disappearance of tariff barriers. Beyond negotiations on customs issues that have begun worldwide within GATT’s framework, turned into the WTO, new common

exchange spaces, which have been created in America or Europe, have had as an effect the acceleration of transnational trade. The introduction of the financial Euro in Europe within less than a year, the likely strengthening of cooperation in the American continent – ALENA, Mercosur and the Andean Pact – shall facilitate even more in the future, for our companies, to have access to export markets. Now, in order to adapt to these new markets, experience teaches us that companies often use “ad-hoc” structures that is, affiliates, in each country where they establish themselves.

Organizations of this nature allow them to take into consideration local peculiarities. But these affiliates also generate exchanges between entities linked among them, therefore representing, a risk in what price pertains.

The second decisive factor of the international development of the companies: the progressive reduction of transportation and communication costs. These reductions made companies to seek their costumers very far away. Currently, a revolution is taking place in this scope, of which we can only appreciate the premises with the rapid development of the Internet technology. Delivery costs are considerably reduced for services of every nature, but assets such as software – with the entire diversity of this concept – music, movies . . . in summary, an essential part of the common commodities in our modern societies.

With the Internet, the world market concept acquires a new dimension: companies have easier access to transnational customers. The accessibility of these new technologies enables smaller companies to promote themselves beyond national borders and create or by at the same time, through some “clicks”, the entities under which they shall perform their exchanges. In the small global web world the issue of transfer prices is not just exclusive of some large multinational companies.

Beyond this first phenomenon of the globalization of economic exchanges, which is very well known, a second important but less familiar evolution for observers is characterized by modalities of recent development in our companies: the fragmentation of functions among multiple entities.

This is why organization charts reveal to be more complex everyday. Juridical and financial links that an entity maintains in its group multiply. Let's take the recent example of a French company examined by the DGI services, the same is typical of a situation that all our administrations know. This company pays its headquarters for the use of a service: the right to use the group's trademark in France. The same provides and invoices technical assistance services to all the entities of the group. In the name of the other branches of the headquarters, it distributes in France products manufactured abroad. It also sells abroad through its branches, products manufactured in France. This example perfectly illustrates the intertwining of the national company examined by an administration within the network of the internal relations of the group.

In the same manner, a recent and generalized trend has been observed in the core of the multinational groups. Corporations in charge of production, up to now autonomous, are placed under the technical dependency of another corporation of the group to which they must pay a commission. While formerly, the company bought its raw material to transform it, it now turns into the simple depositary of the raw material and it is dedicated to piecework. While it used to sell its products, these are now marketed throughout the world through a specialized structure owned by the group.

These juridical and financial transformations are accompanied by a considerable modification of the profit levels made by the company, since every function exercised, every risk assumed, generates invoicing. Operational changes to which said transformation purport to lead are not always reflected in the facts.

In reality, they may conceal an optimization on behalf of the group of the localization of their profits. Even if the transformation is real, the valorization of the functions and the risks, which originates invoicing, often it could give place to a debate with the tax administration.

Therefore, this second function fragmentation phenomenon within multinational groups implies, as well as the globalization and concentration of the exchanges, a greater change for our administrations, regarding the examination of transfer prices.

B. The necessary mobilization of administrations:

Regarding these challenges, our administrations must mobilize. This mobilization passes through two stages: an increase of access to information and the development of new professional skills.

Access to information is an essential requirement for the successful control of the transfer prices. It supposes cooperation between States as well as cooperation on behalf of the company.

Cooperation between States takes place by resorting to international administrative assistance. This resource must allow one to surround oneself of all necessary information for the exact perception of the examined company and its surrounding, of the price levels practiced by the other affiliates or companies comparable thereto or the justification of the transfer prices granted to the group's corporations. I would like to stress on the importance of information regarding comparable companies: this price concept practiced by comparable companies serves as a base for the provisions established in the core of the OECD (Organization for Economic Cooperation and Development). Now in the practice of the comparables, beyond the price itself, it also supposes a comparison of the functions assumed by the entities to which we are referring to, since a difference of functions justifies a price difference. We must admit that the States show themselves to be reluctant to deliver data related to companies that are not directly involved in the examination performed by the requiring State and that can only serve as a reference to appreciate compliance with the principle of open competition. We must then deploy collective efforts at the height of the existing challenges.

Cooperation on behalf of the company regarding the delivery of information in general does not bring greater satisfaction. In the framework of the examination, conflicting relation do not facilitate spontaneous cooperation between examined companies. In France we were able to obtain from the legislators a new type of specific procedure for the control of transfer prices. The same enables the written request to the company of information that the company did not provide when it was requested verbally. If no response if given, the company may face a fine. And above all, the taxation judge

may authorize a tax correction of an approximate amount if said approximation is the product of the lack of cooperation on behalf of the company.

Beyond the access to information difficulties, the second large characteristic of the examination of the transfer prices consists in that the same obliges auditors to leave aside their traditional working methods. Therefore, the development of control of this nature in France implied the specialization of our auditors and a specific effort in training issues.

The task of auditors regarding transfer prices places them at the meeting point of three different issues, leading them to explore the economic field (understand the business of the examined company, including its strategy, its commercial policies, unit costs structure, and its operational organization), the juridical field (the basis of the flows that are being controlled), and the tax field (treatment given to the operations examined).

Our own experience has lead us to select a specialization system. At the core of the National and International Examination Directorate, which in the DGI is in charge of controlling the main international size groups, a specialized team of auditors in transfer prices was created around mid ‘90s. These specialized auditors work as experts, subsidiary contractors for that part of the control of a company. The aid the main auditor in charge of the general control of a company. This organization was conceived in response to the specialization of company consulting services, but it also seeks to disseminate transfer price comprehension in the group of control brigades.

Later, computer support was put at the disposition of the general auditor and transfer price specialist. A computer expert may be required by the auditor to carry out determinate computer processing related to the examined company. This processing may help to reconstruct the company’s analytical accounting and understand cost formation, allowing in this manner the valorization of functions assumed.

Further to the specialization of some, an important effort has been carried out in the training of all our agents in charge of tax control, in the initial preparation stage as well as in the education framework

throughout their professional career. Access to the world market and therefore, from the point of view of the tax administration, to the "transfer price" risk, on behalf of ever-smaller companies, demands the mobilization of the totality of our services.

2. TRANSFER PRICE CONTROLS FACE DIFFICULTIES THAT LEAD THEM TO GIVE GREATER PRIORITY TO PREVENTIVE SOLUTIONS

The difficulties of transfer price controls are mainly due to a particular incomprehension existing between the companies and the administration. Therefore, preventive solutions based on common analysis, must have priority.

A. Difficult examination

In fact, transfer price control may result in situations that place the administration or the company or both in difficulties.

For the administration, it is very difficult to manage access to information and the instability of the organizational structures of the international groups.

I have already described the difficulties regarding access to information in an administrative assistance context. But the complexity of the comparisons that an examiner must perform to establish the base of a corrected in transfer price matters transcends this framework.

Comparable companies must in theory correspond to some identical exchanges practiced by independent companies that exercise the same activity in the same conditions that the examined companies. Due to experience, it is somewhat difficult to find comparable companies. First, because activities are never carried out under similar conditions. Furthermore, to make sure that the operation conditions are similar an in-depth investigation of the companies that are sought to be used shall be required. But investigations of this nature may only be carried out in the scope of an examination.

There are also cases where comparable companies simply do not exist. The concentration operations that I already mentioned lead to the reduction in the amount of independent corporation where the auditor may establish a base and it must be admitted that in some industrial sectors, there simply are no independent companies that exchange products similar to the product for which an open competition price is sought to be determined. It turns out that the verifier must perform a long and complex investigation without being assured that he will end the problem.

To the difficulties related to the search of comparable companies we have to add those that have to do with the instability of the group's organizations. I previously mentioned the complexity of the organizations that arise as from the fragmentation of functions of the companies among multiple entities as a growing risk factor in transfer price issues. Our experience pertaining to the examination of groups has taught us that these organizations are not only complex, but also above all unstable, this makes even more delicate the study thereof. This instability is maintained through internal re-structuring, the establishment of sustained external growth policies or concentration and alliance phenomena.

If the transfer price control experience is difficult for the administration, it is likewise the same for the examined company. For it, access to information is not always easy and corrections are not always understood.

The examined company not always has the required information and in goodwill it could not be unable to satisfy the auditor's demands. Up to not so long ago, many companies did not really know why determinate price was practiced among affiliates. This price came from former agreements which origin was unknown.

This argument was frequently used during the first transfer price control and currently is not valid, since the need to support practiced prices is known by all tax specialists. But this situation may still take place in some small companies.

It also happens that headquarters does not deliver to its affiliate all the information required within the control framework. Multinational groups are organizations submitted to force relations – relations that, in addition thereto, sometimes play a

decisive role in the determination of internal price assignment – and information is a key element in power challenges in a company. The tax expert or the financial director of an affiliate does not always win the battle.

Even when the information is available, companies do not always understand the administration's position. This incomprehension is inherent to the matter that is still even more related to the art of approximation than to exact sciences.

Beyond the mere principle of open competition OECD defined some price evaluation methods that serve as a reference for all and may direct companies in the definition of their transfer prices. But these principles may be of complex application and the exact price estimate is not always easy. The demonstration always results to be, in certain stage of reasoning, in highly subjective elements, and therefore, capable of generating different interpretations between the company and the tax administration. The company does not always accept these discrepancies when the appreciation difference is the basis for the correction of many millions of Euros. This brings as a consequence that, often, these corrections give place to negotiated solutions between the company and the administration, which at the end, is something good.

Notwithstanding, the administration and the company may both fact a common difficulty: the diverging analysis from another administration. In effect, a transfer price correction sets forth the share of profits between two entities that we shall designate as "A and B". If part of the profits is returned to the accounts of corporation "A" under examination, logically the other entity "B", sees itself cutoff from the returned profit. Now, if B already paid the tax on benefits, its tax administration see the obligation to grant a retroactive reduction from the amount of its profit and reimburse the tax difference. The tax administration of corporation B, in some manner has to pay the invoice from the tax correction of corporation A performed by the other tax administration. This what specialists call "correlative adjustment."

Since no tax administration likes the idea of such particular perspective, quite often the same questions the analysis performed by the verifier of the other administration. This situation has two highly concerning consequences: The first is to increase incomprehension on behalf of the company that is in the midst of contradictory tax administration demands and does not really know where to turn.

This situation of complete juridical insecurity if very difficult to tolerate. The other consequence is that if the administrations do not reach an agreement, the company sees in practice that the same profit is taxed twice, which is an economic aberration that all our tax administrations try to avoid.

It is true that there are friendly settlement procedures between our administrations that must allow to eliminate these cases of double taxation. However, we must recognize that said procedures are long and tedious, with a result that is not obviously guaranteed. The burdensome issue of the same affects our administrations as well as the companies.

I would like to briefly remind you that in order to surpass this difficulty, an innovative experience has been introduced in Europe: it consists in resorting to arbitration. The European Agreement on Arbitration dated July 23rd, 1990, as amended on December 21st, 1995 guarantees the elimination of double taxation in the case of the review of the amount of the partner company's profits. The same foresees the creation of a commission formed by the competent authorities, when the same do not reach an agreement regarding the friendly settlement in a two-year term. Competent authorities are obliged to abide to the opinion of this institution, which issues its opinion in a six-month term after they have taken their post. In this manner, European companies are benefited with the guarantee being able to free themselves from double taxation in concept of transfer prices in the center of Europe.

The experience is too recent to be able to take out from it all necessary conclusions, but maybe the prompt explanation of the generalization of this procedure worldwide is crucial.

B. From there a preventive focus

While a solution of this nature is adopted, all the difficulties that we have just mentioned should lead us to prefer prevention from examination. It is not case of eliminating control, which shall always be necessary, but in simple terms, to create an environment where it is easier and better accepted.

This preventive management is based on the conclusion of prior agreements in transfer price issues, better known as “advanced pricing agreement”. Procedures of this nature, which some of you have been aware of for some years now, was introduced in France eighteen months ago. The system conceived under the form of a bilateral agreement between tax administrations, allows the company to make sure that the transfer price policy practiced by the same is not questioned by any tax administration. The same responds to the great expectations of the companies, a legitimate aspiration to juridical security, the disappearance of the corresponding risk to its transfer prices. It also allows the beginning of a discussion with the company in a more serene environment than that of under examination.

This procedure does not eliminate the need of an examination, but reduces the same to a compliance control on behalf of the company of the commitments acquired as from the agreement and of the reality of the facts that the same presented during the negotiation.

I am convinced that these procedures are not only highly advantageous for the companies that adopt the same. The science of transfer prices is a new science that needs to be built. In the same manner as any social science, the comprehension of the assignment price formation on behalf of the companies has to progress through the gradual elaboration of universally admitted principles. The APP’s procedure provides to the group of auditors, that belong to the tax administration, to the companies or its consulting agencies, the opportunity to jointly reflect on the principles that must direct the establishment of transfer prices. Upon focusing the procedure during coming years, the same even prevents from falling into the temptation of always looking into the numbers – profit allocation between both administrations – and obliges to concentrate on the principles. Its advantages are not small.

On this optimistic note I would like to conclude my presentation. We have seen that the price transfer issue is an important challenge faced by our tax administrations in a globalization exchange context. More than a challenge, it is even a threat regarding the capacity of our administrations to control the total tax base in their territories.

However, we must not forget that before being a threat, the transnational development of trade exchanges is an opportunity for our companies and consumers. Let's just say that this economic reality imposed on us, places our tax administrations in front of the challenge of being able to also achieve adaptation to globalization, the opening to international issues. And this challenge, we can only face it together.

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Case study:

TOPIC 4.1

CONTROLLING THE VALUE OF INTERNATIONALTRANSACTIONS (CUSTOMS VALUATION AND TRANSFER PRICES)

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CONTENTS: First Issue: Scope of Customs Valuation and Transfer Pricing.- Second Issue: Is "Actual Value" the Same as the Arm's Length Price?.- Third Issue: Related or Associated Enterprises.- Fourth Issue: Methods to Determine "Actual Value" or "Arm's Length Price". - Fifth Issue: Relation Between Customs Valuation and Transfer Pricing.

FIRST ISSUE: SCOPE OF CUSTOMS VALUATION AND TRANSFER PRICING

Customs duties are levied only on the importation of goods, whereas transfer pricing deals with all business relations between associated enterprises; transactions in tangible as well as intangible goods and services provided between related enterprises. Valuation of goods for customs purposes **is** determination of the taxable basis. In transfer pricing such valuation is only one step in the determination of the taxable basis. All conditions relating to the transaction must be taken into account to determine what is an **arm's length profit** to be derived from it.

SECOND ISSUE: IS "ACTUAL VALUE" THE SAME AS THE ARM'S LENGTH PRICE?

Article VII of the General Agreement on Tariffs and Trade 1994 governs the valuation of goods for customs purposes. In principle other relations between the importer and exporter are irrelevant for customs valuation purposes.

Internationally the arm's length principle is laid down in Article 9, para. 1, OECD Model Convention. That Article does not even mention the price or value of the transaction, but focuses on the **profits** derived from transactions between associated enterprises and on the state in which these profits will be taxable. Valuation of the object of transactions can only be first step in that process.

THIRD ISSUE: RELATED OR ASSOCIATED ENTERPRISES

The description of what constitute related or associated persons differs, apart from the fact that for customs purposes individuals are dealt with as well as legal entities, whereas for transfer pricing purposes individuals are not mentioned.

FOURTH ISSUE: METHODS TO DETERMINE "ACTUAL VALUE" OR "ARM'S LENGTH PRICE"

If there is no price, or the price invoiced is not acceptable as basis for taxation, the "actual value" for customs duties must be determined. According to Article VII GATT the "actual value" should be the price at which the same or likewise merchandise is sold or offered for sale (in the country of origin) in the ordinary course of trade under fully competitive conditions. An arm's length price is defined as the price used in an identical or comparable transaction between independent parties under the same or substantially similar conditions; the comparable uncontrolled price (CUP). This CUP, however, is only one element to determine what is the profit at arm's length to be attributed to each of the associated enterprises.

For customs purposes there can be only one amount that represents the actual value of the imported good. “However, because transfer pricing is not an exact science, there will be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable” (OCDE Guidelines, par. 1.45).

FIFTH ISSUE: RELATION BETWEEN CUSTOMS VALUATION AND TRANSFER PRICING

Is or may customs value be relevant for transfer pricing? Answer conditional yes. Customs value cannot, however, directly determine arm’s length profit and, consequently, cannot be sole justification for profit adjustment as mentioned in Article 9, para. 1, OECD Model Convention. Overview and evaluation of differences. Emphasis in Guidelines on transactions and transactional methods is justified? Text of Article 9 seems to indicate more general approach. In customs valuation the individual transaction relating to specific goods is necessarily the sole object of observation.

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Case study

TOPIC 4.2

INSTRUMENTS AND PROCESSES FOR CONTROLLING OFFSHORE ACTIVITIES AND TAX HAVENS

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CONTENTS: Low Tax Jurisdictions.- I. Background.- II. Concept of Investment in Low Tax Jurisdictions (JUBIFIS).- III. Countries Considered Low Tax Jurisdictions.- IV. Obligations to Provide Information.- V. Revenues Originating from JUBIFIS.- VI. Income Tax Assessment.- VII. Cases in which the Revenues Generated by the JUBIFIS Shall not Be Considered Cumulative for Purposes of the Income Tax Law.- VIII. Payments to Residents in JUBIFIS.

LOW TAX JURISDICTIONS

I. BACKGROUND

In recent years, tax havens or low tax jurisdictions have proliferated and become generalized due to the appeal they present to investors everywhere, in terms of the payment of taxes. For this reason, the treasuries of all the countries have issued rules for regulating investments made in this type of jurisdiction.

In view of the above situation and in order to counteract the aforementioned problems, our country has made several modifications to the Income Tax Law, for the purpose of creating mechanisms that may prevent taxpayers from eliminating, reducing or deferring their tax obligations by channeling their investments, operations and income to countries that are considered of low taxation. In addition, it has established rules whereby the Tax Administration may obtain from its own taxpayers, information with respect to such investments, operations and income, thus endeavoring to adapt the tax system applicable to international operations, in accordance with the practices and treaties to avoid double taxation.

Besides preventing the use and instrumentation of operations in low tax jurisdictions, on classifying as an offense, noncompliance with the obligation to report on investments made directly or indirectly in low tax jurisdictions, such modifications consider company profits as cumulative income, even before their distribution and increase the withholding rates applicable to any type of payment or consideration made to residents in the aforementioned areas.

II. CONCEPT OF INVESTMENT IN LOW TAX JURISDICTIONS (JUBIFIS)

According to the Income Tax Law, investments in JUBIFIS are those made directly or indirectly in branches, corporations, real estates, stock, bank or investment accounts, as well as any form of participation in entities, trusts, partnerships, investment funds or any other similar juridical entity created or established according to foreign law, located in said jurisdictions even those made by means of an intermediary.

In spite of the above, there are certain exceptions to this type of investments, which mainly consist of the following:

a) Corporations located in JUBIFIS that may have been established in accordance with the Mexican laws.

b) When an indirect investment is made in a JUBIFIS, through the intermediation of a resident entity of a country whose legislation calls for anticipating the accumulation of revenues originating from JUBIFIS and the taxpayer has the documentation accrediting such anticipation.

The countries to which Mexico recognizes this type of legislation are the following:

Germany
Australia
Canada
Denmark
Spain
United States of America
Finland
France
Indonesia
Japan
Norway
New Zealand
Portugal
United Kingdom
Sweden

c) Those represented by means of stock participation that does not allow the taxpayer to have effective control of these investments or the control of their administration, it being understood that such controls are available when the taxpayer may decide the time to distribute profits, either directly or through an intermediary. In this sense, it is important to mention that for these purposes, the law presumes, except for proof to the contrary, that the taxpayer has influence in the administration and control of this type of investments.

III. COUNTRIES CONSIDERED LOW TAX JURISDICTIONS

Currently, the Mexican legislation has classified 93 countries as JUBIFIS, among which, the following stand out:

Hong Kong
Cayman Islands
Bermuda
Kuwait
British Virgin Islands
Puerto Rico
Canary Islands
Monaco
Panama
Costa Rica, etc.

IV. OBLIGATIONS TO PROVIDE INFORMATION

In order to obtain information on investments made or maintained by Mexican taxpayers in countries considered low tax jurisdictions, the Income Tax Law provides for the obligation of individuals and corporations to file in the month of February of each year, an information return with the following data on their investments:

a) Types of investments
b) Name of the financial institution or corporation where the investment is maintained
c) Amounts invested
d) Average daily participation of the taxpayer in the investments

With respect to investments in corporations, partnerships and trusts, the following additional information is requested:

a) Fiscal revenues and profits generated
b) Type and amount of assets owned by the resident entity in the JUBIFI
c) Option for accumulation (Gross income or tax result), etc.
d) Name and signature of the taxpayer filing the return or his legal representative, etc.

In this respect, it must be noted that nonfiling of the aforementioned return, or filing more than three months after the expiration of the term, is considered an offense subject to three months to three year imprisonment.

V. REVENUES ORIGINATING FROM JUBIFIS

In principle, all the revenues obtained from entities located or residents in JUBIFIS, se shall be considered as generated in Mexico and shall be part of an independent fiscal result, which is subject to tax at the rate of 35%, for which reason, this is a cellular- type system.

It must be clarified that revenues originating from JUBIFIS are accumulated annually and are not part of the basic revenues for making advance payments.

VI. INCOME TAX ASSESSMENT

According to the provisions of the Income Tax Law, income originating from the JUBIFI, for purposes of calculating the Income Tax that will be paid in Mexico, shall be determined according to certain circumstances, as follows:

a) The taxpayer making any of the aforementioned investments, which, in case the tax authority makes use of the examination powers, does not make available the accounting records, must calculate the applicable Income Tax by adding up all the revenues provided in the Income Tax Law which are generated by the investment made in the JUBIFI, as if it were a branch located in the national territory, without any deduction and paying 35%. In this sense, it is important to clarify that cumulative revenues of the JUBIFI shall be determined every calendar year and shall not be added to the taxpayer's other revenues, even for purposes of the advance payments.

b) Those taxpayers that make available their accounting records to the authorities and file on time the information return on their investments in JUBIFIS, must determine their tax by calculating a base as if it were an entity located in the national territory, by adding the totality of revenues established in the Income Tax Law and subtracting the authorized deductions provided in said Law, with the alternative that the vouchers supporting such deductions, do not have to comply with the requirements established in the Fiscal Code of the Federation in force, since they are vouchers issued by residents abroad. Additionally, if a positive base (tax profit) were generated, in this case they may amortize the tax losses generated by the JUBIFI itself in the immediately five preceding fiscal periods.

   As in the previous option, the tax result of the JUBIFI, will be determined every calendar year and shall not be added to the taxpayer's other cumulative revenues, even for purposes of the advance payments.

   In this accumulation option, it is important to mention that the fact of having the accounting records available to the tax authorities, infers, in addition, the obligations related to the

accounting records, such as that the accounting and financial records should be in Spanish or translated into said language, that all the transactions be registered in Mexican pesos or, if another currency is used, the figures be converted in accordance with the rate of exchange of the foreign currency in Mexico, on the last day of the calendar month.

VII. CASES IN WHICH THE REVENUES GENERATED BY THE JUBIFIS SHALL NOT BE CONSIDERED CUMULATIVE FOR PURPOSES OF THE INCOME TAX LAW

a) Residents in Mexico with an investment in JUBIFIS, which have no influence on the administration or effective control, shall accumulate the revenues originating from their investment, until the time the corresponding dividends are made known.

b) Those resulting from corporations located in JUBIFIS carrying out business activities and where at least 50% of their total assets are devoted to such activities.

c) Residents in Mexico with an investment in JUBIFIS that does not exceed 160,000 Mexican Pesos will pay Income Tax and shall accumulate revenues up to the dividends are made known and the latter are actually received.

VIII. PAYMENTS TO RESIDENTS IN JUBIFIS

Any person, entity, trust, partnership or any other juridical organization which is constituted in accordance to foreign law, located in a JUBIFI, and receiving revenues whose source of wealth is in Mexico, shall be subject to a withholding of 40% of such revenues, without any deduction from the resident in Mexico or resident abroad with permanent establishment in the country making the payment.

This provision significantly limits the transactions with residents in JUBIFIS, since the Income Tax rate is very high and the person living in such areas would be unable to pay such tax, which would represent a very high cost that certainly would prevent such operations.

Lastly, it must be mentioned that in addition to the foregoing provision, residents in Mexico making payments to residents in JUBIFIS, in order to deduct such payments, and in addition to the aforementioned withholding, must prove that the amounts or compensations paid are calculated at market values, which undoubtedly involves an additional limitation to carrying out such operations.

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Case study:

TOPIC 4.2

INSTRUMENTS AND PROCESSES FOR CONTROLLING OFFSHORE ACTIVITIES AND TAX HAVENS

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INTRODUCTION

Fiscal evasion by taxpayers is among the most pressing problems currently facing tax administrations around the world. The means by which a country must combat tax evasion are often complex, as befits a complex problem. The introduction of offshore tax havens into the mix serves only to make the problems more complex and the measures to combat the evasion more difficult to undertake.

In order for tax administrations to effectively fulfill their mandate in combating evasion through tax havens, they need to have a complete basket of tools. In Canada, we consider that this basket necessarily

includes legislation that conceptually addresses the possibility of income being earned offshore and the potential attraction of not reporting that income. It also includes the gathering of information and undertaking the structured analysis necessary to identify general areas and specific taxpayers of concern. It involves turning this information and analysis into tangible compliance actions by the tax administration. Lastly, as no country can realistically address this problem on its own, international cooperation between like-minded countries is necessary to effectively counter tax evasion in the international context.

THE LEGISLATIVE FRAMEWORK

A. Why are specific rules needed to address offshore income?

Many countries have broadly similar rules dealing with the imputation of passive foreign source income. This is not particularly surprising for two major reasons. Firstly, the tax systems of many countries are, themselves, broadly similar. Most countries tax passive income of their residents on a worldwide, rather than territorial, basis. (A few countries, of which the U.S. is the most significant, also tax their citizens who are non-residents on their world incomes.) Secondly, many countries tend to have social systems and other government programmes that require significant tax revenues to support. The tax rates required to support these programs provide some incentive, or a basis for rationalization, for taxpayers attempting to avoid or evade tax.

Generally, countries do not tax non-residents unless the non-resident earns certain income within that country. Non-residents may be subject to withholding taxes on passive income earned from sources within the country, and will ordinarily be subject to tax on substantially the same basis as residents on income from carrying on a business, undertaking employment or the disposition of certain capital property situated in that country. As well, most countries recognize the separate existence of corporations from their shareholders and of trusts from their beneficiaries.

Given these general concepts, and barring specific rules to deal with the situation, taxpayers could simply transfer income producing investments to a corporation or trust resident in a low or no tax jurisdiction, and avoid any tax on the income by their country of residence.

Canada's approach to taxing income earned offshore does not vary greatly from that of many other countries, and contains, at least in broad terms, the legislative tools needed to deal with this issue. As such, Canada has three types of complementary rules relating to income computation. Three general sets of rules dealing with the acquisition by the taxing authority of information supporting, inter alia, such income computation have also been developed.

THE LEGISLATIVE FRAMEWORK - INCOME COMPUTATION RULES

1. "CFC" Rules

Many countries have rules to impute to their resident taxpayers certain passive income earned by foreign corporations that are controlled by resident taxpayers. Often, income from certain transactions that residents have with their foreign affiliates (in which there is a significant but less than a controlling ownership interest) may also be imputed.

These rules are internationally referred to as "Controlled Foreign Corporation" or "CFC" rules. Although they may vary somewhat, the underlying concept is essentially the same in each jurisdiction – to prevent the avoidance of residence country taxation by simply investing offshore. The Canadian rules are often referred to as "FAPI" rules, the acronym for "foreign accrual property income", the passive income that Canada's rules are designed to impute.

CFC rules or their equivalents are most often applicable to trusts as well as to corporations in order to prevent taxpayers circumventing the CFC rules by simply changing the type of vehicle used.

Canada has special rules that impute income of foreign trusts to Canadian residents in certain circumstances. These rules, which currently are applicable where there is a Canadian beneficiary, are being modified to also apply where there is a Canadian contributor to the trust.

2. "FIF" Rules

Similarly, many countries have rules to impute to resident shareholders/stakeholders earnings from investments that represent less than controlling interests in foreign entities. These rules are often referred to as "Foreign Investment Fund" or "FIF" rules. Canada's current rules contain a purpose test that has proven difficult to apply. Accordingly, the rules are being revised to apply regardless of the purpose of the investment being located offshore.

3. Transfer Pricing

Many countries are also concerned with whether amounts charged between related parties for cross-border transfers of goods and services and for the use of intangibles, often referred to as "transfer prices", are appropriate. These rules are often accompanied by administrative regimes to provide "advance pricing agreements", whereby the taxing authorities affected and the taxpayer agree to recognize a particular pricing philosophy for limited periods of time, subject to renewals.

Canada's tax law has, for many years, contained rules that applied to transfer pricing. Those rules were updated in 1998 to introduce specific requirements for documentation of prices used and penalties applicable in certain cases of inaccurate prices, and to conform in some respects to the Transfer Pricing Guidelines issued by the Organisation for Economic Co-operation and Development (OECD).

We are of the view that our new rules have substantially increased the attention paid by taxpayers to compliance with our transfer pricing rules and similarly improved the information available by which we may ascertain their compliance. While transfer pricing concerns do not exist solely for transactions conducted with entities residing in tax havens, the enhanced information available allows us to more effectively isolate those transactions in havens which are of concern, and for which we would otherwise have significant difficulty in obtaining useful information.

THE LEGISLATIVE SCHEME - INFORMATION REPORTING RULES

1) Foreign Reporting Rules

A number of countries are concerned that they have inadequate information regarding foreign investment by their residents. They may also have a general concern that, while their legislative rules are substantially adequate, the rules are not widely followed. In part to determine the possible extent of that problem, and also to remind and encourage taxpayers to report foreign source income, some countries have adopted rules requiring disclosure of foreign income producing property, and of transactions with foreign based entities.

In 1996 Canada introduced requirements that residents report certain details of foreign investments, transactions with offshore trusts, and details of foreign affiliates and transactions with those affiliates.

2) Foreign-Based Information

Canada has a rule, as do a number of countries, permitting its tax administration to issue a requirement on anyone carrying on business in their country for the production of foreign-based information or documents. This is an important tool to preclude taxpayers from preventing the verification of income by locating books and records outside the country. The sanction for non-production is that the information cannot later be produced by the taxpayer in a tax court, as well as making the person potentially liable to fines or imprisonment.

3) Exchange of Information Under Tax Treaties

Exchange of information provisions in bilateral income tax treaties are another means of obtaining foreign based information. A broad network of treaties can contribute to the general compliance atmosphere as taxpayers may have a reasonable expectation that information will be exchanged and will therefore be more inclined

to report income earned in other countries. However, in many countries and very frequently in tax havens, banking and corporate secrecy laws may inhibit the release of information important to the examination of a particular taxpayer's affairs. Additionally, in most cases there will not be a treaty with a tax haven.

II. INFORMATION – THE FOUNDATION OF COMPLIANCE

On a practical basis, the legislative requirements to provide information must be turned into information of sufficient detail and in a convenient format to be useful in determining the extent of a taxpayer's compliance. Canada achieves these objectives through various means.

Canada has general tax information returns for individuals (T1), corporations (T2) and trusts (T3). For business operations we require financial statements, details on types of business operations, forms detailing relationships with foreign operations, and details on foreign tax credits claimed.

With respect to foreign business activities and investment, Canada has a number of special annual information returns. These provide information necessary to track activities and business income and expense flows both into and out of Canada. These include:

- A return (T106) required to report non-arm's length transactions between Canadian taxpayers and non-resident persons including the sale of goods and services, rents, royalties and intangibles, as well as financial transactions i.e. interest, dividends, loans, advances, investments and similar amounts.

- A return and information slips (NR4) required to be filed in respect of amounts paid to non-residents which are subject to Canadian withholding tax, such as pensions, annuities, interest, dividends, rents, etc. This information is often used in exchanges of information with treaty partners.

- A return (T1134) required to be filed by residents to disclose ownership information regarding foreign affiliates (FA) and controlled foreign affiliates (CFC's).

- A return (T1135) filed by residents to disclose foreign investment property with a cost greater than C$100,000.

- A return (T1141) required for transfers or loans to a non-resident trust, identifying the trust, its settlors, trustees, beneficiaries and other relevant information.

- A return (T1142) filed for distributions from and indebtedness to a non-resident trust.

Many of our returns and forms have been revised to allow for electronic filing. As well as being convenient for taxpayers, electronic filing greatly facilitates data capture and analysis. In the past, it was necessary to keypunch all data received in order for it to be available for online access and risk assessment.

Risk Analysis – Effectively Targeting Resources

Information without analysis is not particularly useful. Tax administrations have to respond to the risks associated with non-compliance. Since it is not practical to audit every taxpayer, tax administrators must target those most likely not to comply. This can be done by identifying, measuring and ranking the risks associated with different categories of taxpayers having similar opportunities for not complying such as those taking advantage of tax havens. This type of analysis is usually part of a risk management process whereby risks are identified, measured, and ranked.

Categorizing Risk

Canada considers that there are specific compliance risks associated with the transactions and assets that are attracted to tax havens. They may be classified as mainly administrative (offshore income and assets not reported) or technical (income underreported through transfer pricing).

For corporations and businesses, a major administrative risk is the non-reporting of investment income earned by related parties located in a tax haven. A major technical risk is the transfer of

profits through various arrangements in the trade, finance, administration, cost sharing, licensing, leasing, insurance and shipping areas. For individuals, a major risk is the failure to report funds received or transferred from abroad or the income or gains realized on assets held offshore.

III. MEASURING RISKS

Different methods and data are available to identify and measure the compliance risks associated with tax haven activities. These can be grouped according to the source of data and types of comparison performed. The data relied upon can be reported by taxpayers ("reported data"), collected on audit or reassessment actions ("audit data") or from external public sources ("external data").

For Canada, the data on the T106 and NR4 forms referred to previously are examples of reported data. External data would include Statistics Canada's trade and investment flows between Canada and other countries. Data on audit adjustments are recorded and categorized in an internal database.

Different methods and combinations of information can be used to measure different types of risks:

A. Reported vs. Reported Data: The information provided by taxpayers can be compared with what was given by the same taxpayer in previous years or by other taxpayers in similar circumstances (e.g. industry or occupation). It can involve comparing information from different sources including growth rates or deviations from benchmarks.

B. Reported vs. External Data: The data provided by taxpayers are compared with external data available on similar transactions and assets. These types of comparisons can point to significant discrepancies between reported and official data and the extent of non-compliance with reporting requirements. Comparisons could focus both on discrepancies in volumes of transactions as well as on differentials in trends between reported and official data.

C. External vs. External data: Publicly available data can be analyzed to determine the extent and types of risk associated with certain transactions, for example to compare trends in trade and investment flows between Canada and selected countries to determine the impact, if any, of tax preferences or exemptions.

D. Audit vs. Reported data: Comparing audit with reported data to measure the extent of associated compliance risks can be done by analyzing the results of auditing specific taxpayers and transactions to similar transactions reported by other similar taxpayers.

E. Audit vs. External data: Typical audit or other adjustments can also be applied to public or external data to measure the extent of compliance risks. This approach can circumvent the problems created by non-compliance with reporting requirements since it is unlikely that external data can closely match the types of transactions and payments to which audit adjustments were applied.

In Canada's experience, reported data are generally best suited for the identification of taxpayers and transactions at risk while audit data on reassessment or adjustments to taxable income are the most suitable to determine the potential tax gap or revenues at risk. External data can be particularly useful to determine the extent of compliance with reporting requirements or to identify broad categories of transactions requiring further scrutiny.

IV. COMPLIANCE PROGRAMS

The ultimate goal of obtaining and analysing information is to enhance the effectiveness of programs designed to ensure compliance with the legislation. In Canada's case, we have a number of compliance programs, certain of which are focused on offshore activities.

Matching of data (including foreign matching)

A number of matching programs are in place whereby information provided on prescribed forms from business operations, employers, contractors, banks and other sources are computer matched against the information provided by the taxpayer. Additionally, there are matching programs which utilize information received from treaty partners under the exchange of information provisions in our treaties. Of particular utility are records from treaty partners received in electronic format.

1. International Audit Program

Canada's International Audit Program is specifically designed to address international issues including transfer pricing, "foreign accrual property income" or CFC rules, offshore trusts, and foreign information reporting. Audit teams with targeted training have been formed to deal with each of these unique areas of concern. Specialist international auditors are consulted on all audits of large corporations, and also undertake their own workload, which may entail the auditing of offshore operations or investments, frequently in the jurisdictions where those operations are situated.

2. International Cooperation

There are a number of international organizations that foster cooperation among tax administrations that take on policy studies, aid in setting international tax standards, and in the sharing of best practices. Canada participates in several of these organizations, including CIAT, OECD, the Pacific Association of Tax Administrators (PATA), and the Commonwealth Association of Tax Administrators (CATA).

With regard to tax havens, probably the most important initiative that Canada is involved in is the OECD's Forum on Harmful Tax Practices ("the Forum"). This initiative seeks to curb the impacts of harmful tax competition undertaken by tax havens, by OECD member countries and non-members alike. It is doing so by pursuing adherence to basic principles of equitable taxation by all countries. These principles are comprised primarily of transparency, non-discrimination and the effective exchange of information.

Canada is fully supportive of the objectives of the Forum, and considers that both OECD members and non-member countries would benefit greatly by the success of this initiative in improving the compliance environment, lessening the opportunities for tax evasion and providing better tools for tax administrations to combat evasion when it does occur.

Tax treaties are another means of international cooperation which is important to counter the effects of evasion. In a general sense, treaties for the purpose of preventing double taxation improve the tax environment for the international investor or business, and in so doing lessen the motivation for participating in evasive practices. More specifically, from a compliance perspective, the exchange of information provisions contained in treaties can be an excellent source of information for tax administrations about income earned by residents in other countries. Simultaneous examinations of a taxpayer by treaty partners, also conducted under the auspices of the exchange article in treaties, are another useful cooperative tool. As a last resort, “Assistance in Collection” provisions in treaties can be used under some circumstances to collect taxes from persons otherwise beyond the reach of a country’s tax administration.

Canada also cooperates on bilateral and multilateral projects with other countries aimed at addressing specific multinational industries or projects. One particular initiative is the Seven Country Tax Haven Working Group consisting of Canada, the United States, Japan, Australia, Great Britain, France and Germany, which primarily serves a forum for these administrations to share best practices with regard to tax haven issues.

Lastly, in respect of criminal activities such as money laundering, to which there is often a tax component, requests for assistance may be made pursuant to a mutual legal assistance treaty (MLAT). Assistance can be provided in several ways, such as gathering information or records for investigation, by taking commission evidence for a prosecution, search and seizure, and the enforcement of fines and confiscation orders

CONCLUSION

In conclusion, an effective strategy for combating tax evasion through tax havens requires a multi-faceted approach. It requires legislation, information, analysis and compliance initiatives all directed specifically at the issues created by the earning of income offshore. Lastly, it requires, and in future will require more, cooperation between tax administrations in affected countries.

CIAT is a reputable, well-established international organization. By considering the topic of tax evasion and tax havens at this General Assembly, as well as in its research and technical assistance activities, CIAT can make an important contribution to our collective interest in combating this problem.

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Case study:

TOPIC 4.3

INTERNATIONAL ADMINISTRATIVE COOPERATION FOR COMBATING TAX EVASION AND CONTRABAND

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CONTENTS: I. Introduction.- II. Globalization – Profile, Fundamental Components and Dominant Ideology.- III. The Decisive Importance of Administrative, Tax, Fiscal and Customs Cooperation – ATC.- IV. The European Union and Portugal. Record of Some Initiatives and Proposals in the Context of Administrative Tax Cooperation (ATC).- A) The Continuous Process Aimed Towards Fiscal Harmonization.- B) The elimination of fiscal borders within the European Union, as of 1993.- The "package of measures against prejudicial competition in fiscal matters in the European Union".- D) The ad hoc group of the European Union's Council in the framework of the struggle against fiscal fraud (second half of '99-mid-may, 2000).- V. Some Elements on the Operation of the ATC in Portugal.- VI. Conclusions.

I. INTRODUCTION

Our participation in this Program of Activities of the 35th CIAT General Assembly will focus on a positive energy concentration on two fundamental concerns and we will therefore make an effort to:

- Underscore the superlative importance that the "tout court" cooperation has in the framework of a globalized free market system, in which we are included, reinforcing, by inherence and justly, in our opinion, the conventional importance and peacefully attributed to the administrative cooperation of tax matrix (fiscal and customs).

- Confer, in the proposed general and particular contexts, a **proposal**, in the sense that, at the CIAT headquarters and of its 35th General Assembly, Portugal becomes, in this beautiful city, capital of this beautiful country – as it is nowadays, a geopolitical unit with clear evidence, also in the **tax field**, at the service of the **common interest**, that many others share: a defender of an open society as a universal principle and agent of concrete consequent actions, although, and always, partial and imperfect in the road to (the unattainable) perfection.

II. GLOBALIZATION – PROFILE, FUNDAMENTAL COMPONENTS AND DOMINANT IDEOLOGY

1. The current globalization (or "worldization" as some prefer to call it), euphemism of a **global capitalist system**, fundamentally presupposes, the mobility of the production factors (with the exception of land: but not the raw materials produced by the land) and the elimination of barriers in the international transactions of goods and services.

It also supposes:

Access to information (in real time) as knowledge has become a crucial production factor, given the conditions of instantaneous access to "data-information";

The invasive pressure, of a totalizing trend, of the market mechanisms in all human activity areas;

- **The triumphalism of a profit concept: maximum in the minimum**

- **time (immediate) and exclusivist in the context of interests (selfish)**, that pretend to erase the notion of support which must be linked to the same, except if dominated by the logic of self interest: in this case, the aforementioned concept is transfigured in survival, isolation in the attitude and predator in the acts: in that manner the concept of altruism (common interest) is anathematized and, apparently doors are shut to the **cooperation; in the practice, its need will be manifest** and the same explodes into multiple signs, forms and instruments.

2. Currently, in the global capitalist system, opposite to the idea already presented by us in the introduction, of an imperfect society capable of infinite improvement, the **full self-regulation** capacity is also axiomatic, requesting that, once the necessary information is available (in other words, that the complete information **'is possible'**), the 'invisible hand' (maximized sum of rational actions of a chain of individual agents – logic of the collective equalized to the sum of individual behaviors) will be in charge of correcting conjecturable or structural distortions (e.g.: euphoria cycles – cooling in the international financial markets): the trend may only be the (re) balancing and, therefore, the **rupture** of the global capitalist system is an **impossibility** (or a hypothesis that is not considered).

   The global capitalist system is **perfect** and, when great crises burst (e.g.: the Great Depression, the Asian, Latin-American and Russian Crisis), the responsibility may be attributed to "exogenous clashes" (e.g.: contribution of the media, creators of unrealistic scenarios; in the same manner that physics separate factors that may disturb the "way we would like to demonstrate" the theory, it is not recognized that "the future when it takes place is influenced by the decisions of the participants, based on a prevision that was anticipated").

3. The current Secretary of the Treasury of the United States, Paul O'Neill, is unequivocally in favor of the perfect market thesis. In an interview granted to the "Financial Times" on February 15, 2001, before the last G7 meeting, in Palermo, Sicily, he delves into that, when there is the pretense of avoiding crises from developing, the mistake is made of impeding markets from operating freely. He adds that a financial crisis is not responsible for the failure of capitalism, but it is for an absence of capitalism. More capitalism, not less capitalism is, therefore, the correct recipe. He coherently compares the IMF and the World Bank with a "firemen's corporation" and presents the idea that those institutions should never provide responses to emergencies.

4. The existence of economic prosperity-recession cycles in global economy is not denied and, by being unable to evade the idea that financial capital is the key to the whole system, the governing ideology categorically expresses the conviction that the market mechanisms, by themselves (when considering any form of undesirable "interventionism"), lead to a recessive situation (negative unbalance) to a new balance situation, leaving no doubt with respect to the possibility that the markets may progress towards a point so distant from the "break-even point" from which there is no return.

   Furthermore, in the "new economy" segment it is assumed that, in the companies that compose it, their investment is relatively foreign to the cycles, fact that is yet to be confirmed, mainly in moments where the 'dot.com mania' are undergoing a great decline. For example (Source: "The Economist"- 03. February, 2001): the largest "dot-com" – thanks to massive losses suffered as it grew, true to the implanted "grow quick" philosophy, and at the maximum value assigned to it by the market, since 1997, for three years, more than 100 times (since last Fall, an investor would have lost 80% of the value invested) – now, prosaically and conventionally carries out drastic cuts in its operation costs ("translation" shut down of two facilities and the dismissal of 1300 employees).

5. It is foreseen that the characterization of the current globalization (global capitalist system), more under the functional prism than from the point of view of formal architecture, has a distinctive trait, **currently in debate**, namely the ideology that fuels it, and an **unavoidable** distinctive trait: underlying the global capitalist system we find the **international financial system**, underscored by a superlative mobility of **free capital movements**, facing other production factors and the international exchange of goods and services, with the exception of the information/knowledge service factor.

   Furthermore, with respect to the financial system:

   The **center** is the "diktat" and
   - is focused but not only on one sole issue;
   - determines the world supply of funds;
   - supplies the capital;
   - it fundamentally possesses three natures:
   - International financial markets,
   - "Off-shore" marketplaces (hyperactive system host),
   - Multinational institutions.

   The **periphery** abides by the "diktat" and
   - is the user of the capital;
   - must produce the capital returns in conditions favorable for the center;
   - For the consequences, the capital ceases to irrigate the periphery, both directly in the shape of portfolio credits and investments, and indirectly through multinational institutions.

   The global capitalist system emergency dates back to the 1973 oil crisis.

   However, the development of the international **financial** system is due to the rise to power of Margaret Thatcher and Ronald Reagan in the 80's and is concomitant to the rise to power of market fundamentalism: rejection to any state intervention in order to enable the market mechanisms to operate at will and a ferocious monetary policy that firstly resulted in two factors: a world recession and the deflagration of an international crisis, derived from the 1982 non-payment of foreign debt ("the lost decade" for Latin-America).

And follow the road to success, dotted with difficulties already illustrated by examples in item 2.

6. **Geopolitical realism** is the overlap of **market fundamentalism** for international relations.

   Geopolitical realism encompasses national interest, self-interest market fundamentalism and, due to its invasive insatiability in all spheres of human activity, tends to transform all human relations (in this case international) into transactions.

   Along with these doctrines, as a basis for self-interest as an exclusive attitude, we find **social Darwinism** that legitimizes within the society the idea of survival of the fittest.

   There is **common denominator** in the three foregoing doctrines: their **disdain towards cooperation**.

7. The global capitalist system is the reality. The ruling thesis for its operation is market fundamentalism whose postulates have already been mentioned. The antithesis is communism which, curiously, postulated sorts of globalization with the rise of the work factor, and which has already shown the evidence it had to show.

   The target synthesis, a **global cooperating society**, upheld by us, has a base postulate, opposite to that one of market fundamentalism, which is the **trend for the inherent financial system unbalance** (and not solely attributable to “exogenous shocks”) **and its subsequent possibilities of collapsing**, in the event of the lack of counter-powers (generated inside the democratic system but outside the financial system) that assist for its balance (that avoid sliding into points of no return); namely the making of collective decisions so that market values (social and political) may not be imposed upon others; otherwise, the supremacy of social and political values, not for crushing competition but to not leave the economy devoted to a non-linear (unpredictable) dynamic which, therefore, may cause an irreparable loss; the development of a global economy, accompanied by the development of a global society (the base unit of political and social life still is the

nation-state, but a global society does not mean a global State). The assumption that the behavior of financial markets, heart of the global capitalist system, is, essentially, unstable, unpredictable, first imply a political objective which undoubtedly is: **maintaining the stability of financial markets**.

Cooperation, in the multiple vectors where it may develop and in the multiple instruments it may generate (without detriment to risk, and risk does not cease to exist not as an absolute) must produce, with the **competition** factor a synthesis that makes the above mentioned objective feasible, through a new paradigm: the **co-competition**, as it is called by some. Otherwise, from some point on (the same), competition destroys

When considering the operation of the system in abstract and mechanist terms (the paradigm of physics: orbital harmony, universal mechanics) we think of individuals (singular sets) but not of **persons**, in spite of all the terrifying things this implies, in the face of large crises or complete collapses. The suffering of human beings may help us to be more positive, and the biological paradigm of neural networks (relational) will, most likely, be more compensating.

III. THE DECISIVE IMPORTANCE OF FISCAL AND CUSTOMS, ADMINISTRATIVE TAX COOPERATION - ATC

1. ATC, in our opinion, is a strategic subset of a goal to achieve: an international political system, whose expressions exist but have not achieved a relational consistency so that it could be said that, although not perfect, it necessarily has a life of its own.

The international political system will be that where cooperation, duly internalized by the nation-state, its in supremacy to the point of giving priority to serving the eminent self-interest (or common interest).

To that end, we will have to deepen the concretion of the nation-state at the service of a civil society capable

of satisfying needs for which the State must not be responsible, thus minimizing the trend of the same towards a state control of the economy.

2. Communications play a key role in the context of a globalized society, which, opposite of what happens with the economy, still does not possess, as we have already mentioned, with relation to the global political system, an encompassing density and relational representativeness (only a transnational one) to be able to attribute to the same a life of its own.
   However, it is (happily) not mandatory to conclude that:

   - Communications are a factor that disaggregates the State.
   - The nation-state tends to disappear with globalization.

   It is, therefore, the inalienable duty of the states, in our opinion and, along the lines of item II for placing cooperation in the center of the debate on globalization, as components of the nation-state, technically, and from organizational point of view, reinforce cooperation in the administrative cooperation environment and, consequently, ATC, even because the tax systems, the more oriented they are towards ATC, will better serve, within their scope of action, as a counter-power for the trend towards the instability of the international financial system.

3. On the other hand, we know that fiscal competition is a fact.

   The error is the abusive nature the same assumes, in many cases, in a flagrant manner.

   It is obvious that this happens because, among other possible instruments, “closer” to the international financial system (e.g.: the existence of an international supervisory and regulatory entity), ATC is not sufficiently enforced.

4. On the other hand, due to market fundamentalism that transforms the profit concept, expressed in point 1 of II, into hegemonic and exclusivist (if there are no consistent counter-powers at the global level, among which we must consider ATC) the fact cannot be hidden that the international financial system is, in a brutal but perhaps unimaginable manner (not quantifiable with certainty) fed by its own financial flows produced by the informal economy the same launders (in other words, its three main "natures" mentioned in point 5 of II: financial markets, "off-shore" marketplaces and multinational institutions). These monetary flows, with no control (ethically condemnable as a general rule), stress the pressure on the financial system and postpone the existence of a global political system. It is not necessary to prove, so we think, the decisive importance of ATC in the fight against parallel economy in the sense of providing taxation with many **hidden** revenues and the sense of criminality to its deforciants and also, of the focus which must be privileged in taxation.

IV. THE EUROPEAN UNION AND PORTUGAL. RECORD OF SOME INITIATIVES AND PROPOSALS IN THE CONTEXT OF ADMINISTRATIVE TAX COOPERATION (ATC).

1. The European Union is, simultaneously, an important **cooperation** expression and experience.

   Given that, at least in the field of the principles, where some visible corrections occur, is devoted to the social cohesion principle, in spite of the predominant existence of an international financial system it cannot escape from. **(Competition)**.

   For market fundamentalism it will mean transforming a circle into a square, as it "ab initio" rejects international cooperation.

   For us, that believe in a **global cooperating society**, it means that, at this time, the creation of a consistent common currency will imply a common tax policy, which supposes a meaningful raise in efficiency and efficacy within the ATC environment.

2. In the framework of a common tax (fiscal) policy, among **diverse initiatives of diverse nature, framed in an ample concept of administrative cooperation –** o a sense contrary to the trend to identify administrative cooperation with the information exchange activity (closely linked to fiscal control, mainly inspection) – that includes certain political decisions that have made, following certain technical proposals made, some even at a legislative level, we will highlight:

A. The Continuous Process Aimed Towards Fiscal Harmonization (approximation of national legislations of the Member States), which is a positive contribution for the "global cooperating society" we have referred to, mainly fiscally considering assets in an identical manner and not make it depend on the location of the production factors of the fiscal factor (fiscal neutrality).

Several "successful" results have been obtained (in spite of exceptions and updates that are imposed) at the **indirect taxes** level – Value Added Tax (VAT) + Special Consumption Taxes (SCTs).

The same has not occurred with respect to the **income taxes**; however, it must be underscored that, without attempting to be tiresome, the activity developed with respect to subjects such as **transference prices** and other adjacent ones (e.g.: approval of the arbitration convention, forms for prior agreement to any transference price correction, with the possibility of simultaneous or joint revisions if necessary), **taxation on savings** and on **royalties** or the establishment of **code of conduct** to fight practices considered as fiscally detrimental

As it can be seen – due to reason that are not foreign to the interests derived form the "prevailing reason" and of the barriers that, paradoxically, it creates, inducing the contour of points of greater resistance and the cooperating (in) action in the political sphere – **the fiscal harmonization effort** has followed a road in the direction opposite to what is implicit in point III. 4.; **privileges** (or has privileged) **tax control of international exchanges of goods, in detriment of services and capital**.

B. The elimination of fiscal borders within the European Union, as of 1993.

The elimination of borders within the European Union and, therefore, of the controls made by customs services on merchandizes, object of intra-community transactions, arose as an immediate objective to be fulfilled after the entering into force of the Unique European Act, Luxembourg, February '86. The Unique Act established December 31, 1992 as deadline for the adoption of the indispensable measures for the establishment of the internal community market.

This reality is mitigated, once social and economic inequalities shelved the purity of the tax principle in the source (as in any member State, in the transactions of merchandises), by adopting a provisional taxation regime in the destination (general rule), which was maintained after the expiration of the transitory deadline term (December 31, 1996).

Transactions between Member States ceased to be considered as "exports" or "imports"; this terminology applies only to merchandise transactions with "third party countries" or "third party territories" (countries that do not belong to the European Union or to the territories of Member States excluded from the Union fiscal territories).

C. The "package of measures against prejudicial competition in fiscal matters in the European Union" (Debate originated by the European Commission, in Verona, April, 1996).

Objectives:

Need for a coordinated action at the European level, with views to:

- reduce still exiting distortions in the sole market;
- avoid extremely important losses from fiscal expenses, or
- Orient fiscal structures in a sense that is more favorable to employment.

Areas:

- taxation on companies
- taxation on savings
- retention problems at the source applied to trans-border payments ("non-residents") of interests and of rights among companies ("royalties")

Results:

1. Approval, by the Council and representatives of the Governments of the Member States, of a Code of Conduct in the environment of taxation of companies (December 01, 1997).

    - Basically, the Member States have undertook the commitment of **not introducing new prejudicial measures**, according to the Code of Conduct (Freezing) and to **re-analyze the existing positions and the practices in force**, based on the principles underlying those of the Code of Conduct and on the "communication – of pertinent information" and on the "evaluation of the prejudicial measures" (Dismantlement).

    - Still, in what respects to the evaluation of prejudicial measures, from the time the fiscal measures are used to support the economic development of specific regions (e.g.: ultra-periphery regions), an evaluation will be made to determine if the same are proportional and are oriented towards the expected objectives, without attempting against the integrity and coherence of the community juridical ordering, including the domestic market and common policies.

    - **In what respects to the struggle against fiscal evasion and fraud:**

      "The Council invites Member States to fully cooperate in the **struggle against fiscal evasion and fraud, mainly in the environment of exchange of information between the Member States**, in the terms of the respective national legislations.

The Council observes that the **anti-abuse provisions** or countermeasures included in fiscal legislations and in conventions related to double taxation play a **fundamental role** in the struggle against fiscal evasion and fraud" ("highlighting" is ours).

2. Approval, by the Council, of the text on taxation on savings (and the Commission has undertaken the commitment of quickly presenting a Directive proposal, which happened on May 20, 1998). This subject has recently had a push, within the framework of the last Portuguese Chair (first half of 2000). As of 2003, Portugal will substitute the current regime of retentions at the source on savings of non-residents by the **information exchange system**.

3. The Council also considered, in what respects to the payment of interests and royalties between companies (elimination of retentions at the source in the payment of interests and "royalties" between companies), the Commission should submit a proposal from the Board of Directors, which expressed its intention of presenting it and which it effectively presented on March 04, 1998.

D. The Ad hoc group of the European Union's Council in the framework of the struggle against fiscal fraud (second half of '99 – mid-May, 2000)

a) **Portugal** had, in this Working Group, a determining role, in the Chair and in the preparation of the Final Report, "work in progress" carried out since mid- January through mid- May 2000.

b) **Context** of the Ad hoc Group Mandate (parts of the Final Report) "In the European Union, a high degree of integration of economic activities has already been achieved, thanks to factors such as continuous development of the domestic market and of its fundamental liberties, the revolution of communications and the

introduction of the Euro. It is easy to foresee that, in the future, this phenomenon will become more marked at an ever more accelerated rate.

Likewise, national administrations are adapting to this new community and multilateral framework, closing their bonds at diverse levels, given that the classic principle of territorial power is being overcome by the new reality of European construction and the globalization of economic relations.

Meaningful changes are also recorded in the fiscal and customs environment, which improve the operation of the domestic market. The Community Customs Code foresees a global framework for a customs union with a sole foreign border and the elimination of internal borders. The Sixth VAT Directive has been altered to allow for the elimination of formalities for VAT purposes in the internal borders. In a parallel fashion, new instruments have been created for the necessary mutual assistance between administrative authorities, such as Council Regulation (EC) 515/97, related to mutual assistance between the administrative authorities of the Member States, and the collaboration between these and the Commission, in order to ensure a proper application of the customs and agricultural regulations, the Convention established under the shelter of article K3 of the European Union Treaty related to mutual assistance and cooperation between customs administrations, Regulation EEC218/92 that allowed a basic control of VAT in intra-community operations and the alteration of Directive 77/799, destined to expanding this mutual assistance instrument to the VAT environment.

Given that community rules only accidentally penetrate in matters associated with direct taxation, cooperation between tax

administrations, in spite of generally being covered by Directive 77/799/EEC, has supported itself in a parallel fashion on other mechanisms, such as the model-convention derived from OECD work, mainly in the application of the articles related to the exchange of information, in the conventions held with the purpose of preventing double taxation on revenues and net worth and, in some cases, on other specific conventions, of a broader scope, such as the Joint Convention of the Europe /OECD Council on Mutual Assistance on Fiscal Matters.

The adoption of Decision 888/98/EC of the European Program and of the Council, dated March 30, 1998, which establishes the FISCALIS Program, showed that the Member States are aware that the mere existence of instruments that provide a juridical basis for cooperation purposes, although important, is not sufficient by itself. Adequate personnel training, mutual knowledge and understanding of administrative practices, the exchange of ideas between administrations and the use of modern communications and information technologies have been globally identified as essential complements of these juridical instruments.

In spite of considerable efforts and meaningful progress, the Spanish initiative to create the Ad Hoc Group within the framework of the struggle against Fiscal Fraud was born of the conviction that practical results of administrative cooperation between Member States to combat fiscal fraud **still** should be improved considerably.

(...) In its September 8, 1999 session, COREPER approved the Ad Hoc Group's Mandate in terms of the struggle against fiscal fraud (...)

This report corresponds to that request (...) According to its mandate, the group identified and analyzed the weak points, at the legislation level, of administrative cooperation mechanisms and of the community control systems in matters related to the struggle against fiscal evasion and fraud, within the framework of direct and indirect taxes, proposing, as a consequence, the measures it considered adequate for the strengthening of administrative cooperation".

c) **Some recommendations** of the Final Report, which are fundamental and of potentially universal application, **proposals within the context** of this document. International exchanges, even those pertaining to goods, are made within a context where the past, present and future (before, now and after) concentrate as astral matter in a black hole.

Fraud and fiscal planning actors and agents have a very acute perspective of this factor, which they sec to optimize unceasingly.

Perhaps the priority factor for tax authorities in charge of fiscal control, with views to increasing the efficacy of ATC, is to **facilitate the exchange of information**, being a fundamental activity of administrative tax cooperation (ATC), increasing, in turn, the efficacy of "intelligence" in it flow of "administrative digging" and of fiscal control in its operational flow (inspection: audit and/or research) and also, from the organizational point of view, facilitate the coordination of all fiscal control modules and domains. It is essential, for high hierarchies, the duty of attempting, without faltering ("the indefatigable achieve", as written by the great Portuguese writer Aquilino Ribeiro), to provide the human and material needs essential for the swift exchange of information to the soldiers in this was with no holds barred; but

the objective under consideration is not achieved only in the administrative front; consideration must be given to the legislative front and both depend on political will.

Within this framework of a need to increase the speed of the exchange of information, we present some recommendations, although in a "telegraphic" manner, constants from the Final Report of the Ad hoc Group, which, from the aforementioned point of view and within the legislative, operational and control systems perspectives, have been presented to and approved by the ECOFIN Council, on June 5, 1999, same which currently compose, in a substantial manner, the specific strategies of the National Tax Inspection Activities Plan for 2001, and are followed-up (accompanied), stimulated (through own initiatives) by the European Union Commission, mainly within the framework of the SCAC (Permanent Committee for Administrative Cooperation).

c.1) Revision of the national or community legal provisions on secrecy in the sense that some may be carried out.

c.2) Make banking secrecy flexible or elimination of the banking secrecy

c.3) Fraud cases, at least the more serious ones, must be treated with under an exception nature at the level of deadlines established for the exchange of information.

Temporary limits:

- 1 month when the information is available in the databases or in the taxpayer file:
- 4 months, in the other situations.

However, in cases of great complexity where it is not possible to meet the 4 month term, the Member State to which the request has been made must provide either information or a reply, although partial, within that term.

c.4) Elimination of notices to taxpayers, when there is strong evidence of fraud, as the notice may make control less efficacious.

c.5) Possibility of carrying out joint examinations, but not simplifying and always under the leadership of an officer from the receiving member State.

c.6) Shortening of terms for updating the databases for the community system for communications and exchange of VIES (VAT, Intra-community Exchange System) information.

c.7) VIES should include the rendering of services (a matter of information environment, but also of information mobility).

c.8) “Modification of Regulation (EEC) No.218/92 and of Directive No. 77/799/EEC, with the creation, preferably, of a sole and adequate juridical framework that opens the road to the necessary effort of cooperation for the struggle against fraud, thus removing previously identified obstacles” (mainly, in our opinion, those that hinder swiftness in the exchange of information).

c.9) “Provide Central Communications Services (CLOs – “Central Liaison Offices”) with adequate human and material resources, promoting the correct articulation (...) with the anti-fraud units”.

c.10) Promote the direct exchange of information between regional services in certain “business areas”, multilateral controls, controls in border zones, simultaneous controls (delegation of competencies of the competent authority for the exchange of information).

c.11) Administratively sanction the untimely delivery of statements that summarize (where intra-community transmissions, VIES databases support and feeding source transmissions are declared).

c.12) Intensify the spontaneous and automatic (systematic) exchange of information; in this last mode, e.g.: payment of revenues to non-residents.

c.13) Create risk analysis systems, with common community denominators in terms of selection parameters (statistically based and computerized).

Notwithstanding, recommendations contained in the report are more and had an incidence on areas as diverse as:

- the intensification and deepening of fiscal control actions in the creation or perfecting and use of an adequate alert indicators “tableau de bord”, related to the creation of new taxpayers and their fiscal control, to be begun at the registration level, to define risk segments, with a more or less close need for follow-up;

- national inspection plans with community criteria, annually decided upon by the Member States, prior to their elaboration and execution;

- the adaptation of the control systems to the reality of e-commerce;

- the generalization of computer aided fiscal audits;

- the search for **cooperation** (and not just **coordination**) between the fiscal and judicial authorities in the struggle against organized fiscal criminality (there is a recommendation that, implicitly, has that objective, the need to bring the fiscal and judicial areas closer together);

- reinforce the exchange of information between Member States in the following cases:

  . Operations carried out in privileged fiscal regimes located in the European space;

  . Under-billing and over-billing operations with the accompanying implementation of simultaneous control actions;

  . Returns paid to un-locatable taxpayers (e.g. athletes, artists, multinational company executives);

  . Trans-border transactions and operations.

Nevertheless, the **first recommendations** seem to us fundamental for the increase of efficacy of the ample ATC system.

V. SOME ELEMENTS ON THE OPERATION OF THE ATC IN PORTUGAL

Framework

The ATC in Portugal belongs to the Ministry of Finance and to two General Bureaus: the General Tax Bureau (DGCI – fiscal environment) and the General Bureau for Customs and Special Consumption Taxes (DGASCT – customs and fiscal environment), in spite that the Naples II Convention included in the definition of "national customs regulations" the **non-harmonized** Special Consumption Taxes; in Portugal the Automobile Tax (AT) stands out.

1. Fundamental legal instruments

Fiscal Area (DGCI)

- Directive no. 77/799/EEC (Income Tax (IT) and Value Added Tax (VAT))

- Regulation (EEC) no. 218/92 (VAT)

- Conventions to avoid double taxation and prevent fiscal evasion in Income Tax (IT) matters.

Customs Area (DGASCT)

- Regulation no. 515/97 and

- Naples Convention,

In the customs area

- SCTs' Directive (Directive no. 92/12/EEC, for inclusion of the SCTs in the Mutual Assistance Directive (no. 77/799/EEC).

- Directive no. 77/799/EEC is, therefore, a common denominator.

However, with respect to Regulation no. 218/92, related to administrative cooperation in the VAT environment (support of the CLOs, for the VIES database and for the SCAC (Permanent Committee for Administrative Cooperation)) the DGASCT also uses it, as it is the competent party for the collection of intra-community VAT, in the case of new vehicles and of products subject to SCT.

Furthermore, in what respects to the collection of credits, Council Directive no. 76/308/EEC is born, as a legal instrument used for customs and fiscal purposes.

2. Functioning architecture

Any of the models counts with central and regional services. However, there is a great distinction in the basis of two factors: exchange of information and execution of consequent control actions.

DGASCT (in the customs environment, through an adequate communications system):

- regional services already put into practice direct exchange of information with the other Member States; alert messages are still instantaneously relayed to DGASCT's central services and to the European Commission;

- The central level executes fraud research, prevention and repression actions.

DGCI (exclusively fiscal environment)

- All information flows are funneled to the central level (direct exchange with the Member States barely exists at the only the central level as well as the international ones, coming from third countries).

- All actions in terms of operational control (in the field) are executed by the regional services (inspection carried out by the Finance Bureaus) with the exception of those that refer to large companies (special taxpayer registry), responsibility of the central services.

  Independently from other reasons, the why of this reality is evident: merchandises are the target of the customs services (at the very least, the physical relationship between the officers with these is a very close one, within the boundaries of their mission); the target of the fiscal services (DGCI) are those passive individuals (taxpayers or not; registered or not).

3. Difficulties and Evaluation

Common difficulties

- In the (great) majority of cases, there is no feedback related to the results obtained through by suitable information; scarce current means that must be resized.

- Others, particularly felt by the DGCIs (exclusively fiscal environment):

  . Coordination difficulties due to central services in charge of centralizing information in Portugal – Member States and vice-versa (beyond the international ones) are still not encompassed within the inspection;
  . Insufficient functional segregation in regional units;
  . Non-existence of direct exchange of information at the regional level with the Member States (problem currently under study in order to find a solution that responds to specific situations and some Finance Bureaus are carefully selected as a first step: those situations are the multilateral controls, control on border zones and simultaneous controls):

Once these problems are solved (problems that involve specific strategies of the national activities plan for the 2001 inspection), the speed of the exchange of information, spontaneous and by request, will considerably increase as the "bottleneck" of the central services will disappear.

4. DGCI – DGASCT articulation

There is a protocol entered into in 1996 that, in spite of some impacting initiatives, has not produced the expected global results.

There is a DGCI – DGASCT cooperation, at the level of the reformulation of the Collections Directive in Brussels, at the GT level "Customs Fiscal", among other projects.

There is reciprocal will to mutually share consultations to the fiscal control information systems provided by each General Bureau.

Finally, without attempting to be tiresome, the relational deepening is already ongoing with views to the solution of exchange of information related to the exchange of information related to **imports followed by intra-community transmission**. Exemption in imports spreads

to the destination Member State where VAT is paid. This situation currently poses an extremely high risk of fraud and lacks sufficient articulation among customs and fiscal authorities of the importing country.

VI. CONCLUSIONS

1. The ruling doctrine in the globalization process (global capitalist system) believes that economic cycles show a pendulous movement and, therefore, the free, unrestricted play of the market forces (the “invisible hand” of Adam Smith) always leads to borderline situations from euphoria and depression to a point breakeven point (the eternal return). Within this context, the collapse of the system is out of cogitation.

2. There is, however, an enormous minority that does not exclude that possibility, which is based on the idea, that reality is validating, that the markets are, by nature, unstable and that the **trend is towards a total lack of regulation**, subject to leading to its collapse, if there were no external forces that go against that trend and impede unbalances (positive or negative) or irreparable falls.

3. Opposing an automated and closed conception, there is an **open and pedagogical conception**.

4. **Representative democracy is and segregates determining counterpoints**, capable of leading the markets to a minimum stability that does not exclude risk, maintaining **competition** dormant, without allowing it to irreparably slip; **COOPERATION is the central in this context**; the synthesis may be expressed by the word **COO-COMPETITION**.

5. **The global economic system is commanded and has its epicenter in the international financial system.**

   Tax policies that reject unrestricted fiscal competition, which leads, for example, to the degradation of social cohesion and, likewise, **the fiscal control systems that attempt to effectively fight fraud generated by the informal economy and by abusive fiscal planning**

(enormous sources capital that, mediately or immediately, are oriented to the core of the international financial system) **are a stabilizer for the system**: they attract monetary means that would exert pressure increasing the instability of the financial system and, additionally, are increasing the harmonization of the fiscal effort and feeding, alternately, well-being systems. **These policies and these control systems support the need for an efficient and efficacious ATC (Administrative Tax Cooperation)**.

6. Globalization and technological innovation reinforce the mobility of capital movements. **Without cooperation, detrimental competition in fiscal terms increases**.

7. **Capital**, along with information and in a privileged interaction with the same, **possesses and mobility incomparably superior** to that of the other production factors and to the circulation speed of goods and services rendered.

8. **The ATC (Administrative Tax Cooperation)** – as an instrument of a tax policy and component of a tax system – **to be more and more privileged, must be oriented**, at its sources, **mainly for**:

   - **The control of capital revenues;**
   - **The control of services rendered**, mainly due to the optimized interaction that information (knowledge) and capitals have in this segment of business or socio-professional activity.

9. The ATC, at its source of **information exchange, must be largely reinforced in the legislative environment** (through the elimination of obstacles to its action) **and logistics environment** (organization, control systems, human and material resources).

10. According to a unanimous diagnostic at the European Union level, **the main problem that affects the ATC's potential lies in the need to speed up the exchange of information** (there is an doubtless correlation between the success of fraud and the speed of methods in its consummation, including in that speed the mobility of financial and commercial operations and the scarce tangible duration of the operators).

11. Portugal's problems in the framework of the ATC are no different form those identified in the other Member States of the European Union and, perhaps, in third countries.

    It is in the measure in which Portugal belongs to the capital periphery and, the knowledge that fraud and abusive fiscal planning in the periphery feed (although mediately) the core, and problems may face a greater circumstantial acuity, but duly weighed by the country's dimension (estimated by indicators such as the number of economic units that financially and commercially operate abroad – Member States and third countries – the volume of operations in monetary units, the GDP, the GNP, etc.).

    The administrative operation of the ATC mainly demands:

    - a decentralized architecture
    - a considerable resizing, which promotes segregations under indispensable functions
    - A greater participation in the operational information and coordination between the General Tax Bureau and the General Customs and Special Consumption Taxes Bureau.

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Case study

TOPIC 4.3

INTERNATIONAL ADMINISTRATIVE COOPERATION FOR COMBATING TAX EVASION AND CONTRABAND

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CONTENTS: Introduction.- The Role of International Tax Cooperation.- OECD Work on Tax Avoidance and Evasion .- Key Elements for Effective Exchange of Information.- Legal Basis for Exchange of Information.- Building up New Mechanisms for Effective Exchange of Information.- Bank Secrecy.

INTRODUCTION

1. Globalisation and the removal of exchange controls and other barriers to the free movement of capital have promoted economic development. But they have also increased the scope for tax avoidance and evasion, and the loss of tax revenues can be significant. The exchange of information between tax authorities is one of the best ways of fighting non-compliance in transactions across borders. Exchange of information allows the Competent Authorities of treaty partners to request (or to provide spontaneously or automatically) information necessary for a correct application of tax treaties and also to combat tax avoidance and evasion. Tax havens typically have in place laws or administrative practices under which business and individuals can benefit from strict secrecy rules and other protections against scrutiny by tax authorities thereby preventing the

effective exchange of information on taxpayers benefiting from the low tax jurisdiction. In the course of the work of the Forum on Harmful Tax Competition with the jurisdictions identified as potential tax havens, a number of jurisdictions have shown an interest in a co-operative dialogue with the Forum. That dialogue is aimed at changing the features of the regimes in those jurisdictions, which constitute harmful tax practices. The Forum has concluded that, given that the 1998 Report's primary goal is to promote change rather than to apply sanctions, the Forum should differentiate between co-operative and uncooperative jurisdictions in the process of establishing the OECD list of tax havens. Co-operative jurisdictions are those jurisdictions that meet the technical criteria of being a tax haven that are taking concrete steps to eliminate harmful features of their systems.

2. An essential step in the co-operative process is the implementation of a mechanism for effective exchange of information for tax purposes, given that the lack of effective exchange of information is a key factor in identifying a tax haven. Though certain impediments to effective exchange of information are described in Chapter II of the Tax Competition Report, the term "effective exchange of information" is not specifically defined therein. The present note describes the key elements required for effective exchange of information and proposes building up new mechanisms for effective exchange of information with co-operative jurisdictions specifically tailored to the problems raised by tax havens in the area of exchange of information related to geographically mobile activities.

THE ROLE OF INTERNATIONAL TAX COOPERATION

1. To ensure a correct application of tax treaties

   a) When applying an Article of the Convention, the State where the beneficiary is resident asks the other State where the payer is resident, for information concerning the amount of income transmitted.

   b) Conversely, in order to grant the exemption provided for in Article 12, State B asks State A whether the recipient of the amounts paid is in fact a resident of the last-mentioned State and the beneficial owner of the royalties.

c) Similarly, information may be needed with a view to the proper allocation of taxable profits between associated companies in different States or the adjustment of the profits shown in the accounts of a permanent establishment in one State and in the accounts of the head office in the other State (Articles 7, 9, 23 A and 23 B).

2. To counteract international Tax Planning, Tax Avoidance and Tax Evasion

- tax planning: arranging transactions and relationships to take advantage of benefits permitted under domestic laws and tax treaties: legitimate

- tax avoidance: arranging transactions and relationships to obtain unintended benefits from domestic laws and tax treaties

- tax evasion : Action by the taxpayer which entails breaking the law and which can be shown to have been taken with the intention of escaping tax

OECD WORK ON TAX AVOIDANCE AND EVASION

1. In 1977, OECD Council Recommendation to Member countries on tax avoidance and evasion.

2. The creation of Working Party N°8 on tax avoidance and evasion was decided to achieve the aims set up in the Recommendation

1977 OECD Recommendation

3. To strengthen legal provisions and powers for the detection and prevention of tax avoidance and evasion.

4. To facilitate improve and extend exchange of information to combat tax avoidance and evasion.

5. To exchange experiences on tax avoidance and evasion practices, on techniques for detecting and preventing them.

6. The most effective way to ensure tax compliance in cross border transactions is to promote the exchange of tax information, according to the OECD's Committee on Fiscal Affairs which is working on the improvement of the practical operation of exchange since the existing legal basis for international tax cooperation is in place.

7. Two Recommendations have now been adopted by the OECD Council to improve the practical operation of these legal provisions: the Recommendation on the use of Tax Identification Numbers in an international context will use technological developments to improve the exchange of information while respecting legitimate rights of tax payers to confidentiality of tax information; and the Recommendation on the use of a revised OECD Standard magnetic format for automatic exchange of information.

8. All but five OECD Member countries have tax identification numbers (TINs) which are used to match domestic source information against income declared by taxpayers. The use of TINs in an international context will help check the fiscal status of non-residents who receive income against information from source countries in order to grant them domestic or tax treaty benefits and to improve matching information provided by the source country against the income declared by the taxpayer in the residence country.

9. The Recommendation proposes a step-by-step approach that recognizes the differences in Member countries' practices. Member countries should encourage foreign recipients of income to disclose to them the TIN they have been given in their country of residence. Member countries should consider making this disclosure mandatory. When a TIN is not provided, alternative means of identification should be required and strongly enforced. It also recommends to Member countries without a TIN should issue a special TIN for taxpayers with foreign source income or provide alternative means of identification such as a certificate of residence with a serial number.

10. The second Recommendation proposes a revision to the 1992 standard magnetic format, which provides for a standard for automatic exchange of tax information on magnetic tapes and diskettes. The new Recommendation moves further towards EDIFACT standards for better matching of information and for making easier the conversion of the magnetic format into a standard for electronic exchange of tax information.

KEY ELEMENTS FOR EFFECTIVE EXCHANGE OF INFORMATION

1. In general, effective exchange of information depends on: (A) the existence of the information; (B) the legal ability of the jurisdiction requested to provide information to obtain the information in the first instance; (C) a legal mechanism for providing the information to another jurisdiction and (D) other legal and practical considerations. The first two items also relate to transparency, which is another criterion for identifying a tax haven.

A. The existence of the information

2. Obviously, if the information needed to respond to a request is not required to be maintained it may not be available for purposes of exchange of information. Given that the Report on Harmful Tax Competition deals only with harmful tax practices involving geographically mobile activities, the Forum will need to decide what type of information should be required to be available from the jurisdictions for purposes of the examination of taxpayers' transactions or activities involving such activities. Some examples of the types of information that should be required to be maintained in connection with the covered activities are:

   - the beneficial ownership of companies, partnerships and other entities including those operating as offshore regimes (e.g. exempt companies, international business companies);
   - books and records of companies, partnerships and other legal entities;
   - trust information (e.g., type of trust, identity of those setting up and benefiting from the trust);
   - the movement of assets;
   - the identity of managers and beneficiaries of collective investment funds;
   - beneficial ownership of bank accounts and transactional information;
   - in the case of insurance and re-insurance companies, reserves, insurance premiums paid and gains arising on life insurance;
   - details of transactions with related parties.

3. Consideration also should be given to whether the jurisdictions should be required to establish minimum record retention requirements and a means by which to verify the reliability of the records. The establishment of record keeping requirements generally is accomplished through domestic legislation or regulations concerning the relevant business. It may be possible to address at least some of these issues through whatever legal instrument is chosen for exchange of information by including a provision that would override existing internal legislation. It is likely, however, that the jurisdictions would need to enact additional legislation to meet the information requirements set by the Forum.

B. Access to the information

4. If the relevant information exists, the tax authority would have to have the legal authority to compel the disclosure of the information by the taxpayer or a third party (e.g., trustee, and bank). This would mean that the tax authority would have to have adequate sanctions available (e.g., fines, imprisonment) to encourage disclosure of the information. Some jurisdictions may not provide such authority because they do not have direct taxes. Others may have direct tax systems but may rely on presumptive assessments rather than information gathering powers to encourage taxpayers to provide the documentation to support their tax positions. In such countries, the tax authorities would have to be granted the power to obtain the information, if not for their own tax purposes, at a minimum for purposes of responding to a request for information made by another country in connection with the examination or investigation of a taxpayer involved in, or benefiting from, regimes involving geographically mobile activities in the tax haven.

C. Mechanisms for exchange of information

5. Various legal mechanisms may be used to provide for exchange of information. The OECD already has developed a bilateral and a multilateral mechanism for exchange of information: Article 26 of the OECD Model Tax Convention on income and Capital and the OECD/ Council of Europe Convention on Mutual Administrative Assistance in Tax Matters. It may however be necessary to develop a new exchange of information instrument to address the specific issues raised by tax havens.

D. Other legal and practical considerations for an effective implementation of exchange of information

Obtaining the information requested

6. Some countries impose a requirement on their tax authorities that requests for information from entities like banks or financial institutions are channeled through an independent or judicial body. This may apply both for obtaining information for domestic purposes and for responding to a request from another country. The reason for such a provision usually is to provide protection against "fishing expeditions" or unlawful requests by tax authorities. Such provisions are not necessarily inconsistent with the concept of effective exchange of information but would need to be analysed to ensure that the procedures are not so burdensome and time-consuming as to render the possibility of obtaining the information in a timely manner unrealistic.

Disclosure of information received

7. The information obtained received must be kept confidential and may be used only for tax purposes. For the exchange to be efficient it means that the information obtained may be disclosed to persons or authorities involved in the assessment, collection and enforcement of the relevant taxes (including the prosecution or the determination of appeals) and the information may be used only for such purposes.

Quality and timeliness of information exchanged

8. Once an adequate legal framework is in place, what makes exchange of information effective is its quality and timeliness. This requires first to have a tax administration in place and second to have guidelines for the implementation of exchange of information in order to train and motivate tax officials to provide information requested or to identify, in the course of a tax investigation information which may be relevant for a foreign tax administration.

9. If we take the example of exchange on request, there maybe some legal problems; for instance if the request for information is submitted by a local tax official who has not been authorised by the Competent Authority to make such a request. There may also be practical problems; for instance insufficient information is given to identify the taxpayer. In order to overcome these obstacles and improve the efficiency of information, the OECD has designed Checklists of what to include in a request for information and what to include in a response.

10. Current work to improve exchange of information includes looking at how better use of the latest information technology can help. OECD countries have already adopted an OECD standard magnetic format for automatic exchange of information and the OECD is presently examining the security issues raised by exchanging information electronically.

LEGAL BASIS FOR EXCHANGE OF INFORMATION

1. Bilateral treaties based on the OECD Model Convention

1) OECD Member countries typically exchange information with each other under the terms of double taxation agreements that include provisions based on Article 26 of the OECD Model Tax Convention. The primary purpose of such agreements is to avoid double taxation and therefore most of its provisions focus on such issues. A bilateral treaty based on the OECD Model Tax Convention may or may not be an appropriate instrument to use for purposes of securing effective exchange of information from tax havens for several reasons. Amongst the tax havens

there will be some with which it would be inappropriate to enter into a comprehensive double taxation agreement on OECD lines because, for example, they may not have an income tax or there may be insufficient cross-border activity.

2) From an exchange of information perspective, Article 26 of the OECD Model Tax Convention may be inadequate for purposes of securing *effective* exchange of information with potential tax havens. The effectiveness of Article 26 depends largely on the extent to which the domestic laws of the treaty partners permit access to taxpayer information. Article 26 is written in very broad terms but generally results in effective exchange of information between most OECD Member countries because they have broad access to information for domestic tax purposes and their information systems are similar. In the case of tax havens, Article 26 would result in very little exchange of information due to the combination of the current lack of access to information and the lack of adequate record keeping requirements in potential tax havens.

3) On the other hand, Article 26 could provide an adequate legal basis for effective exchange of information for co-operative jurisdictions if the jurisdictions were to make the necessary legislative changes: (1) to require the maintenance of relevant information, (2) to enable their tax authorities to obtain access to that information, and (3) to overcome commercial or professional secrecy barriers. The question would remain, however, as to whether it would be appropriate to enter into a full or abridged income tax treaty with the jurisdiction.

2. A Multilateral instrument the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters

4) The OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters was designed to provide a multilateral means for administrative assistance among tax authorities. It is open to signature by Member States of the Council of Europe and the OECD. Consideration could be given to expanding it to tax havens that are not already eligible for signature as members of the Council of Europe or through their “mother” country. Such expansion would have to be agreed with the Council of Europe and could raise procedural issues.

5) The OECD/Council of Europe Convention, which covers a broad range of national and sub-national level taxes (except for customs duties), provides detailed provisions for three types of administrative assistance: exchange of information, collection assistance and service of documents. Parties to the Convention may reserve on providing collection assistance, service of documents and assistance in taxes other than direct taxes or tax claims in existence at the date of entry into force of the Convention. The scope of mutual assistance provide by this instrument is very broad and encompasses much more than what would be expected from tax havens: exchange of information

6) As stated above with respect to Article 26, the OECD/Council of Europe Convention may also result in ineffective exchange of information from tax havens due to the current lack of access to information in tax havens, and inadequate record keeping requirements that could present substantial barriers to exchange of information.

7) The Convention may not be an attractive mechanism from the perspective of the tax havens if they intend to make the minimum commitment required for co-operation. The OECD/Council of Europe Convention goes beyond exchange of information related to geographically mobile activities, and covers group of countries that is wider than the OECD.

BUILDING UP NEW MECHANISMS FOR EFFECTIVE EXCHANGE OF INFORMATION

1) In the light of the issues raised by the OECD Model Convention and the OECD/Council of Europe Convention, it may be more fruitful to consider developing an instrument specifically tailored to the problems raised by tax havens in the area of exchange of information related to geographically mobile activities.

2) A practical question is whether it would be possible for a dependency to enter into an international treaty, and undertake international obligations, in its own right. The position is likely to vary considerably among the dependencies, and raise some sensitive issues, but it will be necessary to ensure that the tax havens that are invited to participate in an exchange of information instrument are either able to sign such a treaty in their own right or, if not, that the 'mother country' is in a position to ensure that the obligations imposed by the treaty can be enforced in the jurisdiction concerned.

3) The development of an instrument tailored to the problems raised by tax havens could be undertaken in consultation with some of them as part of the co-operative process. The following issues would need to be addressed: the scope of assistance, the types of exchanges to be covered, the requirement to have information gathering powers, the ways to overcome the lack of a direct tax authority to gather the information in some jurisdictions, the limited experience co-operative jurisdictions may have, the use of information etc.

Achievements of Working Party No.8 on Tax Avoidance and Evasion

- Guidelines for competent authorities (to improve the effectiveness of exchanges of information) 1982, 1993.
- Publication of a survey of current country practices 1994 (target taxpayers and their advisors).
- OECD manual on the implementation of exchange 1994 (target tax administrations).
- Proposals to amend Article 26 (passed on to WP1 for consideration).

Work Program

- Monitoring the Recommendation on the use of TINs in an international context.
- Increase compliance in the area of cross border financial transactions.
- Access to bank information for tax purposes.
- International assistance in Tax collection.
- Design of an OECD standard certificate of residence.
- Implications of electronic commerce on tax administration and tax compliance.

BANK SECRECY

1. Bank secrecy is widely recognised as playing a legitimate role in protecting the confidentiality of the financial affairs of individuals and legal entities. It derives from the concept that the relationship between a banker and his customer obliges the bank to treat all the customer's affairs as confidential. All countries provide, to a greater or lesser extent, the authority and obligation for banks to refuse to disclose customer information to ordinary third parties. Access to such information by ordinary third parties would jeopardise the right to privacy and potentially endanger the commercial and financial well-being of the accountholder.

2. Nevertheless, bank secrecy toward governmental authorities, including tax authorities, may enable taxpayers to hide illegal activities and to escape tax. The effective administration and enforcement of many laws and regulations, including those on taxation, require access to, and analysis of, records of financial transactions. Conditions where financial records and transactions can be concealed from, or access denied to, law enforcement officials may present numerous and obvious opportunities to evade and avoid laws covering matters such as taxation

3. Governments of all OECD Member countries recognise the importance of permitting governmental authorities access to bank information for certain law enforcement purposes (e.g., money laundering. Governments of all OECD Member countries also provide their tax authorities, directly or indirectly, with the possibility of obtaining access to bank information for at least some tax administration purposes. The majority of Member countries allow tax authorities to obtain bank account information for most tax administration purposes; a small minority limit access to bank information to certain criminal tax matters.

4. The effective administration of tax systems requires access to bank information. In general, OECD Member countries tax income on the basis of the residence principle of taxation, in accordance with the OECD Model Convention's allocation of

taxing rights between the residence country and source country. Proper application of the residence principle of taxation requires tax authorities to have access to information held by domestic banks and foreign banks in certain cases. Information that tax authorities may need to obtain from banks for specific cases includes information about deposits and withdrawals (e.g., to verify whether there is unreported legally or illegally earned income, false deductions, where there is a suspicion of back to back loan transactions, sham transactions, questions about the origin of funds), signature cards (e.g., to verify the control of a legal entity, to establish links between seemingly unrelated taxpayers), and interest income. Bank information is important to tax authorities not only with respect to the verification of taxpayer's tax liabilities but also for the collection of tax liabilities.

5. Access to bank account information can take several forms. The vast majority of OECD Member countries are able to obtain from banks information about the account of a specific taxpayer by requesting the information from the bank. The tax administrations of some Member countries have the authority, under certain circumstances, to enter the bank premises and obtain directly the necessary bank account information. The tax administrations of other Member countries have direct access to bank information through centralised databases. Other tax administrations may need to use a formal process (e.g., administrative summons, requirement, court order) to obtain such information. Many tax administrations also receive certain types of information from banks (e.g., amount of interest payments) on an automatic basis, which greatly facilitates domestic tax administration and potentially expands the types of information that may be exchanged with treaty partners on an automatic basis. Such automatic reporting also may benefit taxpayers. In some countries, such reporting allows tax authorities to prepare tax returns for their residents, thereby reducing compliance burdens.

6. Allowing tax authorities access to bank information does not jeopardise the confidentiality of the information. Tax authorities are subject to stringent controls on how they use all taxpayer information, including bank information. In addition, all governments have rules to protect the confidentiality of tax information, including severe sanctions for breaches of confidentiality. Article 26 of the

OECD Model Tax Convention, which forms the basis of most bilateral tax treaty provisions relating to exchange of information, also contains provisions to protect the confidentiality of information exchanged by tax authorities pursuant to tax treaties.

7. Denying tax authorities access to banking information has adverse consequences domestically and internationally. Domestically, it can impede the tax authorities' ability to determine and collect the right amount of tax. It also can foster tax inequities among taxpayers. Some taxpayers will use technological and financial resources to evade or avoid tax by using financial institutions in jurisdictions that protect banking information from disclosure to tax authorities. This distorts the distribution of the tax burden and may lead to disillusionment with the fairness of the tax system. Lack of access to bank information for tax purposes also can produce inequities among different categories of income: mobile capital may obtain unjustified advantages as compared to income derived from labour or from immovable property. Further, it may increase the costs of tax administration and compliance costs for taxpayers. Internationally, lack of adequate access to bank information for tax purposes may obstruct efficient international tax co-operation by curtailing a tax authorities' ability to assist its treaty partners, which in turn may lead to unilateral action by the country seeking the bank information. It also may distort capital and financial flows by directing them to countries that restrict tax authority access to bank information.

8. These consequences led the OECD Committee on Fiscal Affairs (hereinafter referred to as "the Committee") to consider the issue of bank secrecy in the early 1980's. In 1985, the Committee produced the report, *Taxation and The Abuse of Bank Secrecy* ("the 1985 Report"). To address the adverse domestic and international consequences noted above, the 1985 Report suggested "increasing where necessary the information available domestically through relaxation of bank secrecy towards tax authorities" by urging tax authorities of countries with limited access to bank information to encourage their governments to relax bank secrecy rules as they apply to tax authorities, using as support for such liberalisation the growing relaxation of these rules in other OECD countries and the recommendations of international organisations such as the Council of Europe.

9. The 1985 Report also suggested that tax authorities make "further use through exchange of information procedures of data obtainable from banks". The 1985 Report offered three ways for tax authorities to achieve this result: a) adopt the view that the exchange of bank information does not pose special problems; b) exchange information to the maximum extent permitted by Article 26 of the OECD Model Convention; and c) provide information to treaty partners on a unilateral basis in appropriate cases. Not all Member countries were able to agree with the 1985 Report. Nevertheless, some progress was made in response to this Report, although further improvements are necessary.

10. The economic, regulatory and technological environment in which tax administrations must now operate is vastly different from the environment extant at the time the 1985 Report was approved. Globalisation, fuelled by the technology revolution of the last decade, has fostered the explosive growth of cross-border transactions. Technological advances, particularly in the area of electronic commerce and banking, have made international banking readily accessible to a wide range of taxpayers, not just large multinationals and wealthy individuals. The elimination of exchange controls by OECD countries and many non-member countries also has facilitated the rapid expansion of cross-border financial transactions. This new era of "banking without borders" has promoted cross-border transactions, presented new opportunities for economic growth and increased living standards world wide, but it also has raised new challenges for tax administrations around the globe.

11. Globalisation, technology and liberalisation of capital movements are creating vast opportunities for commercial transactions. As noted above, these opportunities also are more readily available to a broader spectrum of the population. More taxpayers than ever before have easy access to ways to avoid and evade tax by taking advantage of unduly restrictive bank secrecy jurisdictions. Thus, the potential for abuse created by the lack of access to bank information for tax purposes and the resulting adverse consequences have increased exponentially at the same time that traditional sources of information on these transactions (e.g. exchange controls) have been removed. It has become important

for tax authorities to keep abreast of the similarly increased opportunities for illegal activities and tax avoidance and evasion. The decision by one country to prevent or unduly restrict access to bank information for tax purposes now is much more likely than ever before to adversely affect tax administrations of other countries. For these reasons, tax authorities are more concerned than ever that unduly restrictive limitations on access to bank information for tax purposes in other jurisdictions will increasingly:

- undermine their ability to determine and collect the right amount of tax from their taxpayers, both domestic and foreign;
- promote tax inequities between taxpayers that have access to the technology that facilitates tax avoidance and evasion and those that do not;
- foster the inequity of taxation between mobile capital and income derived from labour and immovable property;
- discourage voluntary tax compliance;
- increase the costs of tax administration and compliance costs for taxpayers;
- distort international flows of capital;
- result in unfair tax competition; and
- hamper international co-operation between tax administrations.

12. Tax authorities have also come to realise that it is no longer possible to combat effectively tax avoidance and evasion without enhanced international co-operation.

13. It is in this new context that the Committee approved the proposal of Working Party No. 8 to review the current position of Member countries on access to bank information for tax purposes and to explore solutions for improving such access.

14. The European Commission has also undertaken to address the specific issue of taxation of cross-border interest flows of individuals. It recently proposed Directive COM(98)295/FINAL which, if

approved, would require countries to adopt one of two options: to withhold tax on cross-border interest paid to EU resident individuals at a rate of 20 % or to exchange information on such interest payments on an automatic basis.

15. More recently, the OECD report, *Harmful Tax Competition: An Emerging Global Issue,* approved by the Council on 9 April 1998, recommended that, "in the context of counteracting harmful tax competition, countries should review their laws, regulations and practices which govern access to banking information with a view to removing impediments to the access to such information by tax authorities".

16. Increasingly, governments also have recognised that permitting tax authorities access to bank information for tax purposes has the potential to strengthen other law enforcement programs, for example, by preventing the evasion of anti-money laundering systems. Some criminals attempt to avoid the application of anti-money laundering measures by financial institutions by claiming to be evading taxes, which does not trigger the application of these systems in many countries.

17. The G7 announced in the 8 May 1998 Conclusions of G7 Finance Ministers that they had agreed to enhance the capacity of anti-money laundering systems to deal effectively with tax related crimes. The objectives of this agreement are as follows:

    1) To ensure that obligations under anti-money laundering systems to report transactions relating to suspected criminal offences continue to apply even where such transactions are thought to involve tax offences;

    2) To permit money laundering authorities to the greatest extent possible to pass information to their tax authorities to support the investigation of tax related crimes;

    3) That such information should be communicated to other jurisdictions in ways which would allow its use by their tax authorities; and

4) That the information passed to tax authorities be used in a way which does not undermine the effectiveness of anti-money laundering systems. The Financial Action Task Force (FATF) decided to expand its work programme to include consideration of the issues raised by the G 7.

18. These recent initiatives reflect the growing interest in encouraging greater access to bank information for tax purposes. The Committee has already taken an important step in promoting access to bank information for tax purposes by requiring that countries seeking accession to the OECD have access to bank information for tax purposes.

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GENERAL REPORT

GENERAL REPORT

Carlos Silvani
Deputy Director
International Monetary Fund

Carlos Silvani

First, I wish to thank the CIAT authorities for affording me the opportunity to report on this conference, particularly as it was held in Chile, where I lived a very intense professional life for eight years.

If I had to summarize the events of this 35th General Assembly of the CIAT in one word, I would choose "excellence." In my opinion, from the standpoints of organization and the high-level papers presented, the 35th Assembly was marked by excellence. From the opening of the conference, honored by the presence of Mr. Ricardo Lagos, President of the Republic of Chile who enlightened all of us with his concern for finding something similar to Nilometry [1] to measure contributive capacity, excellence was the hallmark of all the papers and the entire conference environment.

In addition to their technical excellence, the papers presented by the Domestic Taxation Department have a virtue: they fill us with hope. Since Chile is a developing country, its example provides optimism and hope for those countries also following the development path. After listening closely to Chile's presentation, we may say that the dream can become reality. However, we also learned that this is the result of persistent determination and work,

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[1] *Nilometry was the method used by the Egyptians to measure the rise of the Nile and thereby determine the contributive capacity of farmers.*

accomplished by following specific strategic guidelines that left no room for improvisation. Results have been achieved after more than a decade of efforts guided by stable leadership that has a clear vision of how to attain the administration's objectives. And so, the **first conclusion** to be drawn from all the papers presented at this 35th Assembly is that the dream can become reality and it is possible to have a more effective tax administration. That is, we can reduce evasion and default. However, success does not happen overnight. It is the result of ongoing efforts, over a long period of time, and consistent strategic vision on the part of upper management.

The **second conclusion** is that success in combating evasion requires commitment on the part of society as a whole and its representatives, and depends on many variables. While it is clear that the tax administration has a leading role in this task, it is also true that the task requires the support of all sectors. We all heard Javier Etcheberry comment on the draft law on evasion currently undergoing legislative approval. We heard him say also that when reducing evasion is talked about, everyone applauds, but when concrete measures are proposed, they applaud too—in one's face…. I believe that this thought transcends Chile's borders, and can be applied to most CIAT countries.

Many of the papers also pointed out that taxpayer compliance depends on a number of variables including the efficiency with which the State spends the funds collected, the complexity of the tax system, the effectiveness of the justice system (slow justice is not justice), the resources allocated to the tax administration, the honesty and integrity of civil servants, etc. The papers also indicated that, in practice, high levels of evasion result in an additional burden for compliant taxpayers, who have to withstand unfair competition and higher tax rates than might otherwise exist were the default level lower. It was pointed out that the penalty structure should not lead to overly high penalties which would mean, in practice, the imposition of only very few penalties. Neither should they be very low, possibly becoming an incentive to noncompliance.

The design of the tax system was also pointed out as a major variable in determining compliance. In this sense, it was considered important for the tax system to be as simple as possible, to reduce compliance costs, and facilitate monitoring. This requires that special treatment

and exemptions be reduced to the minimum bearing in mind that, in tax matters, the maxim “if it’s fair, it’s not hard” holds good. Stable tax regulations were also mentioned as facilitating compliance. Even complex tax systems are easier to administer if they do not undergo radical changes and remain relatively stable over time. This enables both taxpayers and tax authorities to become familiar with current provisions, reduces compliance costs, and facilitates monitoring.

The **third conclusion** is that the transparency of the tax administration and its actions facilitates compliance and encourages commitment to combating evasion. Measuring evasion and publishing the measurements are clear signs of the administration’s commitment to transparency. Furthermore, regular publication of these measurements attests to the tax administration’s commitment to gradually improving its effectiveness. Publishing evasion measurements is the administration’s way of showing the use it makes of the resources allocated to it, and of specifying its potential needs in order to improve its effectiveness.

Another clear sign of improved transparency and one that is now appearing in more advanced tax administrations is the communication to taxpayers of information held by the tax authorities in respect of taxpayer transactions. This helps largely to reduce default because taxpayers know that they cannot fail to report information already known to the authorities, since they could be penalized. In addition, sending taxpayers information in the tax administration’s possession assists them in preparing their returns. In most cases, the administration’s information is accepted, or minimal corrections are made, and the taxpayer’s return is then very simply completed, with the consequent saving in labor and a greatly reduced cost of compliance for the majority of taxpayers. This new methodology which is gradually appearing in the more advanced administrations reminds me somewhat of “Back to the Future.” A few decades ago, the advanced concept was “self assessment” or self-reporting, based on the promotion of voluntary compliance. Now, without of course abandoning the promotion of voluntary compliance, the advanced concept is preparation of the taxpayer’s return by the administration, with the taxpayer approving or amending it.

Also as part of what we are calling transparency, we see the determined advance of the Internet in developing different applications—from the most simple, such as querying current legislation, to the most complex,

such as querying databanks prior to authorizing the printing of taxpayer invoices. There is no doubt, as the papers presented inform us, that the Internet is the way and that, sooner or later, all administrations will have many Internet-based applications. This will facilitate procedural transparency and uniformity and will constitute an effective defense against corruption. In some countries today, it is already possible to learn via the Internet whether taxpayers are registered, and the state of pending processes (such as the state of requests for tax refunds), etc. Also via the Internet, it is now possible in some countries to query whether or not taxpayers are "trustworthy" and, as a result, determine the appropriate amount of withholdings. We also heard that in some cases, printing houses can query via the Internet the number of invoices that a taxpayer is authorized to print. This will mean a real revolution in the operating method, to the benefit of taxpayers, because it makes the system in general, and the tax authorities-taxpayer relationship in particular, much more transparent. Procedures and responses received by taxpayers will be standard; processes will be speeded up and resolved in a more objective way, and consequently will be much less vulnerable to corruption.

Furthermore, the transparency resulting from increased Internet use is associated with better service to the taxpayer since many tax administrations already use it to provide—24 hours a day, 365 days a year—free software for preparing returns, as well as various forms, without any need ever to contact the tax administration.

The **fourth general conclusion** to be drawn from this conference is that tax administrations are trying to concentrate all their activity on checking the current taxable period. Clearly, although the statute of limitations can be three or four years, or even longer, the more advanced administrations focus on analyzing the current period. The last return is checked and maximum controls are enforced until the next return arrives. In other words, arrears, or accumulated pending work, do not exist. However, it should be emphasized that those tax administrations following this strategy do all that they can to speed up the checking of returns received before returns for the following period begin to arrive. This is a fundamental strategic change and is the opposite to tax administrations' claims some years ago when they asked for an extension of the statute of limitations in the totally unrealistic hope of being able to check, in subsequent periods, returns they had not been able to check during the current period. The truth is that the previous strategy only resulted in a gradual accumulation of arrears.

Part of the new strategy also includes a tendency to check specific instances of noncompliance, in the majority of cases. This allows for completing audits in shorter periods and making relatively minor adjustments, thereby increasing the possibility of taxpayer payment. However, this does not imply that taxpayers are not subsequently audited and penalized for default or other taxes. Neither does it imply to any lesser extent that comprehensive, in-depth audits should not be carried out. As a result of this new strategic orientation which focuses the administration's activities on the most recent incidents of default, the speakers also pointed out the need to concentrate on the largest defaulters and establish something like a ranking of defaulters in order to prioritize actions.

The **fifth general conclusion** to be drawn is that a number of organizational changes are required to deal with the new environment. The organizational changes introduced in some of the more advanced tax administrations should be noted, where a model focusing mainly on the type of "customer," i.e., the type of taxpayer, has been favored. In other words, organization is constructed around the concept of large, small, individual, etc., taxpayers. This is closely linked to the previous conclusion, because if we wish to design different programs taking into account the need to monitor different types of default, we also have to adapt the organizational system because we know that there is a high correlation between different types of default and specific taxpayer type. Thus default among small taxpayers or individuals is completely different from that observed in large multinational companies, and we must, therefore, have an organizational system that takes account of that fact. Furthermore, not only is an organizational system that considers taxpayer type necessary for better monitoring purposes, it is also essential for improving the service to taxpayers. In the long run, this too will definitely contribute to improved tax compliance. However, the need for adaptable, flexible organizational structures, capable of responding rapidly to requirements was acknowledged, since these are very dynamic and change with a speed that, only a few years ago, would have been unimaginable.

The **sixth general conclusion** to be drawn from this 35th conference is that large-scale cross-checking of data is absolutely essential if we wish to have a tax administration that is even minimally effective. Although large-scale cross-checking of data is seen as necessary and essential, it was also acknowledged that it is inadequate and should be supplemented with specific plans for monitoring default in certain

activities. No technical limits exist today on large-scale monitoring, and the main difficulty is obtaining error-free data from third parties required to submit them. It was remarked that the sending of massive amounts of data submitted by third parties via the Internet and the possibility of validating these data prior to processing is a major step forward in improving the quality of data cross-checking. The need for reliable data from third parties is important not only for monitoring compliance, but also for facilitating the preparation of taxpayer returns with a high degree of certainty—an important service to taxpayers who can thus see a reduction in the cost of compliance. The need for precise, accurate data from third parties is fundamental, since this determines whether or not successive processes that depend on these data will become virtuous or vicious circles.

The availability of reliable data will make it possible to produce accurate tax returns and claims leading taxpayers to believe and have concrete evidence of—that the tax authorities know their economic situation—and the result will be better tax behavior. However, if the data that we receive from third parties is not reliable, the administration will earn the distrust of taxpayers and even of its own employees who will lose their belief in the appropriateness of large-scale data cross-checking. This will result in unenthusiastic work and less willingness to resolve errors, with the ensuing loss of quality and an even worse outcome. Therefore, as far as data cross-checking is concerned, it is the conclusion of this meeting that the best strategy is to begin with only a small number of cross-checks, to ensure data quality. A slow pace is therefore recommended until experience and data validation show that the steps to be taken will result in a high level of quality.

The **seventh general conclusion** is that economic globalization has also brought in its wake a new form of evasion, which must be combated. This type of evasion, called “nontraditional” requires an international response beyond the actions of any one country in particular and requires international coordination. In order to gain control of this type of “nontraditional” evasion linked to the shift in tax bases, it is proposed to:

1. Undertake a free, continuous exchange of information at the international level; and
2. Establish minimum rules, similar to those defined by the European Union, to discourage the adoption of tax systems that may constitute a threat and favor “nontraditional” evasion.

In conclusion, I wish to point out that, in my opinion, as intensive use of the Internet is the most important **technical challenge** faced by tax administrations at the beginning of this century, the problems associated with the shift in tax bases, tax havens, globalization, and the monitoring of “nontraditional” evasion is the most important **political challenge** that we shall face during the first decades of this 21st century.

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RESOLUTION OF THE
35TH CIAT GENERAL ASSEMBLY

Resolution of the 35th CIAT General Assembly

The tax administration's examination function and the control of evasion

Whereas:

Among the various functions of the tax administration, examination appears to be the most complex one and, in addition, plays a preponderant role in the effectiveness of the administration, since it is a fundamental instrument for combating evasion to ensure an adequate level of tax revenues and promote spontaneous compliance with tax obligations.

In order to achieve such purposes, the examination function must create a perception of risk in the taxpayers whereby, as a result of noncompliance with their tax obligations, it may be presumed that there is a high probability of being audited and sanctioned, since this will be a strong incentive for spontaneously and timely complying with tax obligations.

For this purpose, it is necessary to achieve, among other things, some key attributes in exercising the examination function, such as:

The professionalism of officials, in terms of high levels of technical capacity, sense of ethics and service, which may project toward society the image of a fair, efficient and effective tax administration.

The transparency and certainty of the standards and procedures that must be observed, which may allow citizens to be aware and anticipate what they must expect from these actions and, at the same time, which may afford the administration sufficient powers to act and access information of tax interest.

The implementation and use of information systems and modern technology, that may render possible the application of objective criteria in the programming and execution of the examination process and which, at the same time, may allow for a step by step monitoring of such process.

Notwithstanding the importance of the examination function, in many countries it has not been sufficiently developed, when compared with the progress achieved in other functions, essentially due to the scarcity of resources and/or lack of an adequate strategy, as well as because of its natural complexity.

Even in those countries where this function has managed greater achievements, changes in the current economic and technological environment wherein the tax administrations act, have generated new challenges and also new opportunities worth analyzing.

The General Assembly,

Resolves:

To recommend to the tax administrations of its member countries to:

FIRST:

Promote the reduction of tax evasion by endeavoring to collect the taxes in force, as a priority means for obtaining the additional resources required for fiscal financing.

SECOND:

Develop and implement massive tax compliance controls aimed at the universe or broad sectors of taxpayers, with a view to developing a vast tax presence, through the examination of compliance with formal obligations or adaptation of the information provided by taxpayers in their returns to specific parameters or standards.

THIRD:

Promote the development and provision of the necessary resources and instruments for effectively planning and carrying out examination, such as: officials with adequate attitudes and aptitudes, sufficient legal powers for accessing information of tax interest, availability of equipment and technological means of support, risk analysis as instrument for guiding examination and strategies for detecting and incorporating the underground economy.

FOURTH:

Control international operations by giving special attention to transfer prices and customs valuation, identification and implementation of instruments and processes for the control of offshore activities and tax havens and international administrative cooperation as a means for combating tax evasion and contraband.

DAILY SCHEDULE OF ACTIVITIES

35TH CIAT GENERAL ASSEMBLY
DAILY SCHEDULE OF ACTIVITIES

Santiago de Chile, April 2 – 5, 2001

Main theme: **The Tax Administration's Examination Function and Control of Evasion**

Monday, April 2nd

Inaugural Session:

09:00 – 10:00 Inauguration of the General Assembly

10:00 – 10:30 Official photograph

10:30 – 11:00 Coffee

Plenary Session

11:00 – 12:00 **Topic 1:** **The reduction of tax evasion as a means of fiscal financing**

Moderator: Bob Wenzel, Deputy Commissioner of Internal Revenue Service,United States of America

Speaker: Javier Etcheberry Celhay, Director, Internal Revenue Service of Chile

12:00 – 12:20 **Commentators:** Peter Kalil, Jefe División Fiscal, Inter-American Development Bank - IDB

Juan Carlos Lerda, Regional Tax Policy Adviser, ECLA, Chile

12:20 – 13:00 Open discussion

13:00 –14:00 Lunch

Parallel sessions:

14:00 – 14:40 Presentations

Topic 1.1 Tax evasion, tax policy and the market economy

Moderator: Juan José Rubio, Director, Institute of Fiscal Studies of Spain

Speaker: Blaise Phillippe Chaumont,Civil Administrator, Head of Office, General Directorate of Taxes of France

Topic 1.2 The social and political legitimization of the struggle against tax evasion

Moderator: Noel Caballero, Technical Advisor, Ministry of Economy and Finance, Panama

Speakers: Paulo Ricardo de Souza, General Coordinator of the Examination System, Secretariat of Federal Revenues of Brazil

Clive Nicholas, General Director of Taxes of Jamaica

Topic 1.3 The instruments for measuring tax evasion

Moderator: Roy May, Director, Directorate of Taxes of Suriname

	Speaker:	Michael Jorrat De Luis, Head of the Economic Tax Studies Department of the Deputy Directorate of Studies, Internal Revenue Service of Chile
	Commentator:	Carlos Silvani, Assistant Director, International Monetary Fund –IMF

14:40 – 15:30 Guided discussion

Tuesday, April 3

09:00 – 09:30 Reports on the parallel sessions of the previous day

Plenary Session:

09:30 – 10:30 **Topic 2. Massive tax compliance controls**

	Moderator:	William McCloskey, Assistant Commissioner Policy & Legislation, Canada Customs and Revenue Agency
	Speaker:	Alberto Monreal Lasheras, Director of the Tax Management Department, State Agency of Tax Administration of Spain
10:30 – 10:50	**Commentators:**	Teófilo Quico Tabar, General Director of Internal Taxes of the Dominican Republic
		Nelson Gutiérrez, CIAT Consultant, Coordinator of Panama's Tax Modernization Program

10:50 – 11:30 Open discussion

11:30 – 12:00 Coffee

Parallel sessions:

12:00 – 12:40 Presentations

Topic 2.1 **The processing of tax returns for detecting errors, inconsistencies and omissions**

Moderator: Santos Acosta Acevedo, Deputy General Operational Director, General Directorate of Revenues of Nicaragua

Speakers: Benjamín Schütz García, Deputy Director of Examination, Internal Revenue Service of Chile

José Joaquín Cedillo, Head of the Fiscal Programming Division, National Integrated Customs and Tax Administration Service, Venezuela

Topic 2.2 **The control of invoicing and the scheduling and execution of massive examination operations.**

Moderator: Elsa Romoleroux de Mena, General Director, Internal Revenue Service of Ecuador

Speakers: Juan Carlos Carsillo, Director of Programming and Examination Standards,Federal Administration of Public Revenues of Argentina

Jorge Mouchantef, Advisor, Ministry of Economy and Finance, Uruguay

Topic 2.3 **Information systems for supporting examination**

Moderator: Raúl Loayza Montoya, Director, National Service of Internal Taxes of Bolivia

Speakers: Flemming Paludan, Deputy Director General, Central Customs and Tax Administration of Denmark

Bob Wenzel, Deputy Commissioner of Internal Revenue Service, United States of America

12:40 – 13:30 Guided discussion

13:30 – 14:30 Lunch

Wednesday, April 4

08:30 - 09:00 Reports on the parallel sessions of the previous day

Plenary Session

09:00 – 10:00 **Topic 3. Resources and instruments for planning and carrying out examination**

Moderator: Héctor Constantino Rodríguez, Federal Administrator, Federal Administration of Public Revenues of Argentina

Speaker: William Baker, Assistant Commissioner, Verification, Enforcement and Compliance Research, Canada Customs and Revenue Agency

10:00 – 10:20 **Commentators:** Juan Carlos Carsillo, Director of Programming and Examination Standards, Federal Administration of Public Revenues of Argentina

Marie Carlsson, Head of Services and Control Unit, National Tax Board of Sweden

10:20 – 11:00 Open discussion

11:00 – 11:20 Coffee

Parallel sessions:

11:20 – 12:00 Presentations

Topic 3.1 Legal powers of the tax administration

Moderator: Adrián Torrealba Navas, General Director, Direct Taxation of Costa Rica

Speaker: Claudino Pita, Director of Programming and Studies, CIAT Executive Secretariat

Topic 3.2 Risk analysis as instrument for guiding examination

Moderator: Rudy Roberto Castañeda Reyes, Superintendent,Superintendency of Tax Administration of Guatemala

Speakers: Matthijs H. Jacob Alink, Deputy Director Operations & Client Policy, Ministry of Finance of The Netherlands

Topic 3.3 Strategies for detecting and incorporating the underground economy

Moderator: Francisco José Rovira Mejía, General Director, General Directorate of Taxes of El Salvador

Speakers: Concettina Ciminiello, Director, Office of International Relations, Ministry of Finance of Italy

Guillermo Fino Serrano, General Director, DIAN, Colombia

12:00 – 12:30 Guided discussion

12:30 Closing of work (activities) of the day

Thursday,April 5

Plenary Session:

09:00 – 09:30 Report on Parallel Sessions of previous day

09:30 – 10:30 **Topic 4. The control of international operations**

Moderator: António Nunes Dos Reis, General Director, General Directorate of Contributions and Taxes of Portugal

Speaker: Elvin T. Hedgpeth, Deputy Director, International, Internal Revenue Service, United States of America

10:30 – 10:50 **Commentators:** Luiz Fernando Lorenzi, Tax Auditor, Secretariat of Federal Revenues of Brazil

Alberto Barreix, Tax Specialist, Inter-American Development Bank - IDB

10:50 – 11:30 Open discussion

11:30 – 12:00 Coffee

Parallel sessions:

12:00 – 12:40 Presentations

Topic 4.1 Controlling the value of international transactions (customs valuation and transfer prices)

Moderator: Matthijs H. Jacob Alink, Deputy Director Operations & Client Policy, Ministry of Finance of The Netherlands

Speakers: Blaise Phillippe Chaumont, Civil Administrator, Head of Office, General Directorate of Taxes of France

Huub Bierlaagh, Chief Tax Lawyer, International Bureau of Fiscal Documentation - IBFD

Topic 4.2 **Instruments and processes for controlling offshore activities and tax havens**

Moderator: Haseena Ali, Chairman and Commissioner, Board of Inland Revenue of Trinidad and Tobago

Speakers: Eduardo Enrique Díaz Guzmán, General Administrator of Large Taxpayers, Tax Administration Services of Mexico

Rene Fleming, Manager, Policy & Procedures Section, International Tax Directorate, Canada Customs and Revenue Agency

Topic 4.3 **International administrative cooperation for combating tax evasion and contraband**

Moderator: Michele del Giudice, Advisor, Ministry of Finance of Italy

Speakers: José Manuel Franco, Director of Services, General Directorate of Contributions and Taxes of Portugal

Francisco Lozano, Senior Administrator, Organisation for Economic Co-Operation and Development - OECD

12:40 – 13:30 Guided discussion

13:30 – 14:30 Lunch

14:30 – 15:30 General Report: **Carlos Silvani,** Assistant Director, International Monetary Fund - IMF

15:30 – 16:30 Closing ceremony

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Santiago de Chile, Chile
April 2 to 5, 2001

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Presentation on CIAT

CIAT is a public international organization established in 1967 to promote the improvement of the tax administrations through: exchange of ideas and experiences; technical assistance and training; compilation and distribution of information; and promotion of technical research.

The Center is formed by 28 countries from the Americas and five European countries as Associate Members. The Minister of Finance or Treasury of each country designates the positions in his tax administration, the incumbents of which are the Representatives at CIAT.

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