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TOPIC 1.2

RISK ANALYSIS IN EXAMINATION

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Case study

TOPIC 1.2 RISK ANALYSIS IN EXAMINATION

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1. INTRODUCTION

The accounting system of businesses provides the necessary information for managerial decision-making.

Now then, for making decisions within the sphere of fiscal control, which instruments should be used?

In fact, good practice at the level of fiscal control implies the availability of information on the taxpayer population, in relation to which risk profiles should be developed that may contribute to support decision-making, so that the alter may be clear, objective and effective.

Nevertheless, how can one structure an information system that may allow for managing and making decisions within the sphere of fiscal control in an intelligent manner, aimed at the risk?

In order to answer this question, this paper endeavors to show the essential need of information systems for decision-making within the sphere of fiscal control, where risk analysis is posed as the most adequate response.

Thus, on the basis of this premise, this paper is divided into four essential parts:

The first part endeavors to define the principles, objectives and strategies of fiscal control, as well as highlight the importance of risk analysis for the decision-making process.

In the second part, the intention is to characterize the risk analysis model according to its general principles, and most important technical guidelines.

The third part aims to present the structure and mode of operation of the risk analysis model implemented in Portugal at the central examination unit, which is intended for the financial sector and the large enterprises.

The fourth part intends to show that the risk analysis systems are not an end in themselves, but rather must be inserted in a risk management model, which involves not only the risk analysis and evaluation component for the selection of taxpayers, but also the components involving human resources management, taxpayer selection and operational forms, as determining elements of the entire fiscal control process and planning of examination activities.

In sum, it is concluded that it is important to adopt a risk analysis system for the examination control management process, seeking to show its most relevant aspects and some of its limitations.

2. RISK ANALYSIS AT THE CENTER OF FISCAL CONTROL

2.1 Decision-making

Tax administrations should afford agents carrying out activities of an economic nature and all citizens in general, the best conditions so that they may duly fulfill in a simplified manner their constitutionally provided obligation to pay taxes.

Economic agents and citizens in general may be divided into three main groups, classified each by their relative position vis-à-vis the fiscal system and they essentially are:

- those that are registered in the system.
- candidates to be registered and those newly registered in the system.
- the nonregistered that operate outside the system.

In general, some objectives of the tax administrations should be to follow up, through surveillance and control procedures, the behavior of the registered taxpayers, be aware

of the profile of the taxpayers wishing to register and identify and bring to the system all those carrying out activities of any nature, that are susceptible of generating obligations of a fiscal nature who are outside the system operating illegally.

In this way, the tax administrations oblige themselves to adopt strategies in keeping with the reality of those taxpayer groups and which should be implemented through what is habitually known as the fiscal control system, bearing in mind a central objective or, that is: Exercising surveillance and control that may increase the risk of detection of noncompliance and, accordingly, which may promote voluntary compliance with tax obligations.

Within the sphere of fiscal control, as in any other sphere of action, it is necessary to count on adequate analysis and evaluation instruments that may allow for making clear decisions and acting in keeping with the objectives pursued.

We have talked about fiscal control, but how is fiscal control truly characterized?

Fiscal control may be defined as a series of procedures implemented by the tax administrations in exercising their authority, with a view to knowing and following up the activities of the economic agents and the citizens, in general, who are generators of income, endeavoring to prevent illegal behaviors and repressing others, through corrective and disciplinary measures.

Fiscal control is exercised at two main levels: the administrative level and the inspector level.

Administrative control is essentially an automated and massive process, intended to follow up the behavior of registered taxpayers through verification of formal compliance and the coherence of filing actions undertaken and the crosscheck of information compiled from several sources.

Inspection control predominantly involves the substantive verification of actions carried out by the taxpayers to confirm the filing veracity, through the verification of the respective support and recording elements, which should be aimed at well defined targets and where the noncompliance risk is much higher, taking into account the scarcity of human resources available and the high costs associated to each type of intervention.

Therefore, it may be said that the most distinctive elements of these two types of control lie in the fact that the administrative control is fundamentally based on automated and massive procedures, while inspection control must have selective and personalized procedures.

In fact, it is important and, we would even say essential, that there be a clear differentiation between these two types of control, in their objectives, methods and means of action, because only thus will it be possible to establish clear and effective

strategies for compliance with the mission of the tax administrations in the sphere of fiscal control.

On the other hand, in order for inspection control to function as a selective and personalized process, it is important that there be systems capable of providing the necessary information for such purpose.

The answer to this need is apparently simple and definitive: risk analysis.

2.2 The principles and strategies in fiscal control

As any other common organization, tax administrations must seek to use their resources in an economically feasible manner, by optimizing the cost/benefit binomial, although abiding by the fundamental principles of action of public powers, specifically those of equity and proportionality.

In fact, the inspection control actions must involve a personal distribution - individual or collective -, sectorial and geographical, balanced (equity) and an allocation of means as well as a level of depth of the work which should be adapted to the circumstances (proportionality).

Does this mean that the tax administrations in addition to having to maximize the probability of revenue collection in their examination activities – principle of profitability – must also follow the principles of legality provided in the law and of ethics, which are those expected to be adopted by the powers of the authority. The use of the risk analysis systems, as powerful instrument to combat tax fraud and evasion, should not make these principles the subject of arguments, but rather they should be seen as contributing to greater impartiality and justice.

The fiscal control strategies are not determined by the risk analysis, nevertheless, the clear and objective information which the latter provides, contributes to the definition of those same strategies and the decision as to more adequate modes of action for each of the large taxpayer groups in their various positions before the fiscal system.

3. THE RISK ANALYSIS SYSTEMS

3.1 The concepts and elements of risk analysis

The concepts

Risk analysis is a statistical base process, wherein the known objective information dealing with each taxpayer is examined and compared with the results achieved in the

examinations made to that same taxpayer, in such a way that may allow for identifying the elements causing specific behaviors, especially fiscal noncompliance.

Thus, risk analysis seeks to essentially distinguish patterns of behavior, by identifying the factors that influence such behavior which allows, merely in terms of probability, to anticipate the existence of fiscal noncompliances and to quantify the tax that may potentially be found as omitted, in groups of taxpayers with the same characteristics.

The objectives of risk analysis

The objective of risk analysis is to provide adequate information for making decisions in the sphere of fiscal control.

The risk analysis system contributed toward:

- a more effective use of human resources available;
- better selection of taxpayers to be examined;
- more precise determination of the necessary levels of intensity of examination;
- forecasting the recovery of fiscal revenues.

These combined factors thus allow to:

- increasing examination profitability: There is a greater probability of recovering omitted tax, given the fact that the taxpayers showing the greater risk are the ones selected for examination;
- improve the preventive effect: influencing voluntary compliance, given that the taxpayers feel greater surveillance on the part of the administration in relation to acts of noncompliance, which are systematically identified by this process.

However, what is risk for purposes of risk analysis?

Definition of risk

Risk is the expectation that taxpayers will not fulfill their tax obligations, as regards the filing and payment of taxes, by using tax evasion practices through the manipulation of legal provisions in force or the omission of taxable events.

Nevertheless, in the case of risk analysis, it is not only important to define risk, but also to quantify it.

And how can risk be quantified?

The quantification of risk

The risk is quantified by determining the ratio between the expectation of finding an amount of omitted tax and the average time required to detect it; that is, the relationship between a monetary unit and a time unit.

In this way, the risk related to a specific taxpayer, may be quantified, for example, as 1500 Euros for each day of examination work.

The value of the tax per working day, corresponds to the expectations of recovery of the tax in relation to segments of taxpayers with similar characteristics.

The sources of information

The sources of information for the compilation of indicators in risk analysis are basically the following:

- elements voluntarily declared by the taxpayers
- data obtained by the examiners during the examination actions
- results of fiscal corrections occurring after the examinations

Indicators for the analysis

For the classification of taxpayers, risk analysis uses indicators of a varied nature, taken from the information sources previously mentioned, which indicators may be of an objective or subjective nature, or of an economic, fiscal, organizational or behavioral nature.

Objective indicators, of a predominantly economic and fiscal nature are essentially chosen from among the elements declared by the taxpayers, such as, for example, the business turnover, the gross aggregate value, fixed assets, equity capital, profits or amounts of taxes paid voluntarily.

Subjective indicators, fundamentally of an organizational and behavioral nature, result from the examiners' professional judgment during the course of the examination actions and are specifically related to the attitude and responsibility of the taxpayers, the type of business activity they carry out and the forms of organization and complexity of the respective information systems.

The evaluation of risks

Risk analysis calculates the possibility that a taxpayer may not comply with his tax obligations and the corresponding amount of potentially omitted tax, but the decision as to the selection of taxpayers, form of action and allocation of resources should always undergo a process of evaluation by those responsible for the elaboration and execution of the plans.

Risk evaluation is a judgment which confirms in any individual case, through a cognitive process, the existing information and other relevant facts for a final decision.

The final decision should not then be automatic, but rather based on a critical analysis of the data offered and susceptible to being modified following evaluation of concrete cases.

Review of the risk

One of the fundamental characteristics of the risk analysis systems is derived from the fact that all indicators used may at any time be modified for purposes of updatedness or new indicators may be introduced if there is interest in their inclusion as a result of new situations that may be detected by the intelligence services.

Therefore, risk analysis is a dynamic process, wherein the validity and interest of the indicators used may always be considered in determining the risk and also bearing in mind the need to continuously adapt the forms of examination control to fluctuations in the economic and entrepreneurial situations.

3.2 The results produced by the system and the impact on management

The system produces a classification for each taxpayer, integrating them in more or less homogeneous groups, generally with a classification of the alphanumerical type.

In this way it is possible to calculate the necessary human resources and optimize their distribution in accordance with the need of providing attention to each taxpayer group, determining the examination priorities, and accordingly assisting in the elaboration of more effective examination plans.

The system thus allows to determine the examination cycles (average time between each examination), the average time anticipated for each examination and to calculate the amount of tax that may probably be found as omitted for each group of taxpayers, by establishing quantified goals for the results of the examination.

The effect of risk vis-à-vis the relative importance of the taxpayers

The results achieved in the determination of the risk, nevertheless pose some questions in terms of management of fiscal control, given the capability of the great diversity of taxpayers for generating taxes.

Does this mean that, for example, between two taxpayers of the same sector of economic activity, of the same dimension and level of activity, the risk will be greater in the one showing a less credible fiscal organization and behavior, given that the amounts of potentially generated tax will be equivalent and since the tendency for tax omissions or inaccuracies (or even tax evasion or fraud) are greater in the one with a less credible fiscal organization and behavior, obviously, the potentially omitted amount of tax will be greater in the latter.

Inversely, between two taxpayers of the same sector of economic activity, although with a substantially different dimension and level of activity, even though the fiscal organization and behavior of the taxpayer with the lower dimension may be of reduced credibility, the risk could be greater in the taxpayer with greater fiscal organization and behavior credibility. Given that the amounts of taxes potentially generated are greater, from small omissions or inaccuracies there may result amounts of omitted tax that could exceed those that would be found in the small taxpayer with a tendency toward significant evasion.

In fact, since the risk is quantified by the potentially omitted tax, by day of inspector work, the omitted tax of a small taxpayer with an organization and turnover of little significance can never be of high value, for the simple reason that it is impossible to generate it without the corresponding economic activity.

Let us consider as example, the case of a small businessman with sales of € 150 000 and a 30% operational margin, without other charges and of a large industrial business with a volume of invoicing of € 250 million and gross fixed assets of € 400 million.

In the limit, even though the small businessman would not voluntarily declare any sales made, the omitted tax would not exceed € 22,050, resulting from € 8,550 of value added tax ($150,000 - 105,000/150\ 00 \times 0.19$) and € 13,500 of tax on yield ($45,000 \times 0.30$).

On the contrary, the large industrial business with a credible tax behavior, if it incurs in an inaccuracy in its return on yield, with respect to the tax rate of amortization applied to an equipment acquired for € 2,000,000, using a rate of 15% when the maximum allowed is 10%, the resulting omitted tax in that fiscal period would correspond to the 5% difference or, that is, € 100,000.

The dangers of an economic vision in risk analysis

As was seen in the previous section, in the perspective of risk analysis, the risk will always tend to be potentially greater in a taxpayer of a greater dimension, although basically he may be compliant, than in a small taxpayer who, nevertheless shows an essentially noncompliant behavior.

Nevertheless, this methodology should not lead us to give systematic attention to large taxpayers, to the detriment of small taxpayers. In fact, the principle of equity should always be to guide the fiscal control strategies. For this reason, the tax administrations should avoid economic visions of risk management, given that, because of the moral aspect of the fiscal system, the control should be obligatorily applied to the various segments of taxpayers and not merely some of them.

In any case, this does not mean either that the tax administrations should not use their risk analysis systems in such a way as to render profitable their human and material resources, by allocating them in proportion to the risk detected, either by activity sectors, territorial areas or types of taxpayers, but always based on a global control strategy.

4. THE RISK ANALYSIS MODEL IN PORTUGAL

4.1 The segmentation of taxpayers

In Portugal, in this first phase, the risk analysis system being implemented is aimed at the financial sector and large businesses in general. However, for a subgroup of the group of registered taxpayers, there is a system being currently implemented for the group of taxpayers in the registration phase or those recently registered.

As we saw before, risk analysis presupposes the classification of the taxpayers with the subsequent segmentation, according to their characteristics, by putting them together in more or less homogeneous groups and determining for each of those groups, an expectation of tax behavior, associated to an amount of tax that could probably be detected as omitted following the examination action.

The segmentation used in Portugal is based on the classification of taxpayers according to three groups of indicators:

- economic activity sector.
- economic and fiscal importance.
- fiscal organization and behavior.

The risk is thus determined on the basis of these groups of indicators, which concentrate in themselves the most relevant information that may be obtained in

relation to each taxpayer. Thus we obtain an alphanumeric classification for each one, according to the economic activity sector wherein it is found, the *rating* derived from the evaluation of the economic and fiscal importance and the *scoring* which classifies the fiscal organization and behavior.

A potentially omitted amount of tax is associated to each homogenous group thus obtained, (sector / importance / behavior), by day of work and the main types of fiscal anomalies that may presumably be found in the sequence of an examination.

4.2 The classification of the economic and fiscal importance

The relevant indicators

The economic and fiscal importance is translated into a *rating* that considers indicators that show the levels of activity of the taxpayers, such as: turnover, gross value added or banking product, result from leasing or result from factoring, net fixed assets, capital equity, net result of the fiscal period, tax on assessed yield, withholdings at the source (deliveries for tax substitution) and VAT.

By way of example, the following elements may be used for structuring these indicators of economic and fiscal importance.:

a) For TURNOVER:

- nonfinancial businesses: corresponds to total sales + rendering of services;
- banks and other financial corporations: Corresponds to total interest and comparable benefits + yields from securities + commissions + profits in financial operations;
- insurance companies: corresponds to total gross premiums issued + commissions and participation in the results of reinsurance.

b) For GROSS VALUE ADDED:

- Sales + Rendering of services + Variation of production + Works for the company itself + supplementary benefits + subsidies for exploitation – Cost of goods sold and materials used – Supplies and external services – indirect taxes

c) For the BANKING PRODUCT / LEASING / FACTORING:

- Interest and benefits together + yields from securities + commissions (benefits) + profits from financial operations – less interest and costs together – commissions (costs) – losses from financial operations

d) For the NET ASSET:

- value of resources available to the company, net of amortization and cumulative provisions, corresponding to the sum of: fixed + stock + third party debts + negotiable securities + availabilities + increases and –

e) For EQUITY CAPITAL:

- Corresponds to the company's net worth and accounting value consisting of capital stock, supplementary contributions, awards for the issuance of stock, adjustments of parts of capital, reserves and results

f) For NET RESULT OF THE FISCAL PERIOD:

- Corresponds to net profit from taxes, including extraordinary results

g) For TAX ON ASSESSED YIELD

- corresponds to self-assessed tax by the taxpayers in their annual returns

h) For WITHHOLDINGS AT THE SOURCE FROM TAX ON YIELD:

- total of tax withholdings on yield made as tax substitute

i) For VALUE ADDED TAX DETERMINED:

- total tax determined, delivered or reimbursed

Calculation of the *rate*

The *rate* (using a generalized Anglo-Saxon term persistently disseminated in economic analysis and which is merely translated as classification) is calculated as follows:

A reference value is fixed for each of the indicators, which should correspond to the greater value found for each of those indicators, verified in the taxpayer universe being analyzed.

The reference value found corresponds to a percentage of 100% and thus, the values of each one of the remaining taxpayers are indexed at this percentage. In this way, after calculating all the percentages for each taxpayer and for each indicator vis-à-vis the reference values, the simple averages of these percentages are calculated, to find the rate.

For example:

(In 000's of Euros)

TAXPAYER	Turnover Ref.		VAB Ref.		Profit Ref.		VAT Ref.		Rating
	€ 7 500		€ 4560		€ 640		€ 1500		
	Value	%	Value	%	Value	%	Value	%	average
C1	7500	100%	1620	35.5%	150	23.4%	1500	100%	64.7%
C2	5150	68.7%	4560	100%	640	100%	1020	68%	84.2%
C3	3870	51.6%	2780	61%	140	21.9%	240	16%	37.6%

4.3 Grading of the organization and the fiscal behavior

Behavior is defined as the way an entity acts vis-à-vis a specific situation, which in this case is a fiscal one, and therefore it is essential that it be evaluated through objective and subjective indicators, that classify it as a score.

In the first case, when we talk about objective indicators, we are considering the level of voluntary compliance with tax obligations on the part of the taxpayer – terms and credibility of the amounts declared (taxable profit, tax on yield, tax on value added and withholdings at the source) – comparing it with what would be expected from that taxpayer under normal conditions, taking into account his economic importance and the activity sector in which he is involved.

Such objectivity is derived from the fact of considering the compilation of data directly from the taxpayer, which may be eventually compared with other data, normally sectorial ratios and other historical indicators, which are also objective.

In the second case, when we talk about subjective indicators, one considers those whose evaluation results from the professional opinion of the examiners, since it is obtained during the execution of the examination procedures.

The information on the fiscal organization and behavior is obtained through the analysis of two main types of information: the first one emerging from voluntary compliance and the second, the result of the examination procedure.

This grade is determined through *scoring* (again using an Anglo-Saxon terminology which involves points), calculated on the basis of a series of indicators related to the type of organization and behavior, compiled from the returns and payments made by the taxpayers and the elements obtained by the examiners in carrying out their examination functions, as regards attitude, responsibility, activity and entrepreneurial organization and also, through corrections made in the examination procedure.

Let us now consider, in greater detail, the indicators used for determining the taxpayer's fiscal behavior, which for purposes of evaluation and scoring are grouped in blocks in the following manner:

- **Voluntary compliance**

The first block, voluntary compliance, aims to analyze and classify voluntary compliance by the taxpayers. The analysis should be based on the automated identification of compliance with the filing obligations, amount of payment and delivery of tax according to the economic activity, sector and region to which it corresponds, thus constituting a credibility measure which is generally determined through comparison of individually considered indicators with other of a general or sectorial nature.

- **Attitude and responsibility**

Attitude and responsibility are indicators that disclose the taxpayer's tendency and capacity for complying with his tax obligations.

In fact, the experience, managerial stability, responsibility and cooperation with the tax examination of the managerial entities of the business must be evaluated by the examiner, since they may resolutely influence the capability for strictly representing the company's fiscal situation; and it being easily perceived that managerial teams with frequent alterations and some resistance to cooperation, may give an indication of problems in the organization that may be reflected in the veracity of the information available and inevitably in fiscal behavior.

In the meantime, one must balance this evaluation with the evidence or capability for purposes of planning or tax evasion which may be evidenced in the filing process.

- **Entrepreneurial activity**

The entrepreneurial activity also constitutes a series of indicators that must be weighted in the risk analysis. In fact, stockholder control, it is, for example, mostly public or private, or belonging to a multinational group, is relevant for risk analysis. Likewise, the entrepreneurial dynamics and the diversification of the activities constitute evaluation factors of the inspectors, since they may contribute to a better or worst fiscal performance. If a taxpayer shows a stable activity, without regular alterations and centered on a single activity, he may provide greater guarantee of compliance than another with regular alterations and much diversified activities, rendering it more difficult in this case to control fiscal accounting adjustments and the accounting control itself.

- **Organization and Complexity**

The type of organization, bearing in mind the complexity of the accounting and computerized systems, and the way they are organized and presented, are also important elements in the evaluation of the company.

- **Nature of corrections and amount of additional assessments made**

Finally, the corrections made following examination procedures, in terms of value and nature of the omitted tax determined, are naturally fundamental information for evaluation of the taxpayer risk.

How to calculate the score

The indicators of the first block (voluntary compliance) must be determined annually, with the average of cumulative values of the past years being considered as value for the grading.

The second (attitude and responsibility), third (entrepreneurial activity) and fourth (organization and complexity) blocks, are scored every time there is an external examination procedures, barely considering in this case, the last score which substitutes and eliminated the previous one.

The fifth block (corrections and additional assessments made) should consider the average values of the cumulative results of examinations made in the past years. The scores are framed within previously defined parameters (of the scoring grid type) prepared on the basis of rules of knowledge, but always depending on the professional criterion of the examiners involved in the tasks, vis-à-vis the reality perceived.

Scoring is the result (multiplying) of all scores obtained in relation to each indicator. In this way, the behavior is not considered merely the sum of the evaluated parts, given that we are being faced with variables that are interrelated and whose effect, at the level of noncompliance may be exponential.

For example:

<u>Regularity in compliance with filing obligations and the payment of taxes</u>		
All tax filing and payment obligations fulfilled within the legal terms	1.0	X
20% or less of tax filing and payment obligations fulfilled outside the legal terms	1.2	
Between 20% and 50% of tax filing and payment obligations fulfilled outside the legal terms.	1.4	
Above 50% of tax filing and payment obligations fulfilled outside the legal terms.	1.6	
In general, does not fulfill the tax filing and payment obligations	1.8	
<u>VAT delivered / reimbursed (credibility)</u>		

Do you agree with the level of known activity and sector wherein it is included, not having experienced negative variation in relation to previous and/or similar periods	1.0	
Do you agree with the level of known activity and sector wherein it is included, having nevertheless, experienced negative variation in relation to previous and/or similar periods up to 10%.	1.2	
Is not significantly deviated from the level of known activity and sector wherein it is included, having nevertheless experienced negative variation in relation to previous and/or similar periods above 10%.	1.4	X
Is significantly deviated from the level of known activity and sector wherein it is included, there being nevertheless, justifications with some consistency.	1.6	
Does not agree with the level of known activity and sector wherein it is included, there being no justified reason known.	1.8	
<u>Accounting organization</u>		
Well organized and maintained	1.0	
Moderately well organized and maintained	1.2	X
Poorly organized and maintained	1.4	

Thus, this taxpayer's *score*, according to the grids shown would be:

$$1.0 \times 1.4 \times 1.2 = 1.68$$

4.4 Determination of the risk

Grading of the risk

After calculating the *rates* and *scores*, taxpayers are classified and group into segments determined according to numerical parameters. These parameters should be established whenever the calculations of *rates* (percentages) and *scores* (points) are made, taking into consideration the global results obtained. In general, it will be always advisable that the processing of the calculation of *rates* and *scores* occur at time intervals not exceeding one year.

Due to the economic and fiscal importance, taxpayers are classified as A, B and C, depending on whether they are of high, medium or reduced importance.

With respect to the evaluation of the fiscal organization and behavior, taxpayers are classified with the attributes of 1, 2 and 3, depending on whether they show a potentially noncompliant, doubtful or compliant behavior. In addition, attribute 4 is used for taxpayers without any grading due to the fact, for example, of not having been, until the respective moment of the evaluation to any external examination.

Quantification of the risk

On the one hand, we jointly classify taxpayers according to the sector of economic activity wherein they are included, their economic and fiscal importance and the fiscal organization and behavior, by separating them accordingly into subgroups (= to the universe of taxpayers with similar characteristics).

On the other hand, we observe the result of examinations made to groups of taxpayers with characteristics that are similar to those of the subgroups, determining, in average terms, the omitted tax that has been detected (amount of the corrections), number of working days that were required for the effect and nature of the corrections made (by types).

By crosschecking these two groups of information it is possible to determine the trends that characterize the potential tax noncompliance of all taxpayers from the universe that have similar characteristics – activity sector, importance and behavior -, and in addition, in terms of probability of omitted tax, assistance time given to each taxpayer and nature of the typical anomalies that may be found.

For example, it is possible to say that a working day in the bank sector for a taxpayer with *rated B* and with a *score* of 2 is € 3450, which value corresponds to that taxpayer's risk prior to examination or, that is, the tax that may presumably be found as omitted for each working day, with the addition to it, of the main types of anomalies that may be found during the examination.

5. RISK ANALYSIS IN THE EXAMINATION STRATEGY AND PLANNING – THE RISK MANAGEMENT PROCESS

5.1 Decision-making based on the risk

The risk analysis system should be based on a structured global risk management chart, wherein all aspects related to the risk should be considered jointly in a logical, coherent and systematized model.

A globalized risk management model should not merely include the risk analysis system as regards the identification, analysis and evaluation of the risk, but also should include all process involving human resources management, selection of taxpayers by order of priorities and operational actions.

Based on taxpayer profiles developed through risk analysis, it is possible to formulate strategies and make decisions that may involve:

- accepting the risk and not acting operationally
- not accepting the risk and implementing such actions as:

- partial or general external examination
- internal analysis of tax returns
- information to the taxpayers regarding compliance with the obligations
- passing on the risk to third parties, demanding bank guarantees (in situations of fund reimbursements, for example)

5.2 Operational intervention oriented toward the risk

The main objectives of the model developed in Portugal is to determine the intensity and cycles of assistance that should be devoted to each taxpayer, by identifying those requiring higher levels of assistance and thus optimizing the use of human resources by distributing them in proportion to the need for assistance or, that is, the risk.

The information from risk analysis provides the necessary conditions for decision-making. They are initially included in the operational examination plan, which considers the series of operational measures that are adapted to the guarantee of examination coverage of each taxpayer, bearing in mind their risk profile.

In this way, the intensity of assistance that should be given to each taxpayer, determines the levels of operational intervention and the human resources required for its execution.

In general terms, there are four main levels of operational intervention, each of which has differentiated characteristics, which are adapted to the various needs of intensity of assistance determined by the risk, ranging, from maximum intensity of permanent follow up, to minimum intensity of mere monitoring through computerized media of voluntary compliance with tax obligations. Thus, there is:

First level

The type of action at this operational level corresponds to the permanent follow up of the taxpayers, by dedicated examiners, who monthly verify the payment of taxes and respective credibility and systematically identify, through recurrent audits, their strong and weak points of an accounting and fiscal nature.

This level groups all taxpayers with indicators showing the highest level of economic and fiscal importance (classified with an A, regardless of the *score*), or even others who, although not being rated with an A, were considered as high risk in the evaluation process and, therefore, require permanent follow-up.

The *score*, in the case of taxpayers rated A, essentially serves to determine the level of intensity of assistance or, that is, the time that must be necessarily allocated to the execution of the auditing procedures.

Second level

The operational action at this level corresponds to external audits of a general nature.

The objective of this level is to include taxpayers whose fiscal organization and behavior classification appear as not very credible or potentially anomalous, although they are not rated with an A

Third level

The type of operational action at this level, is essentially based on the internal analysis of the accounting-fiscal information, it being possible in specific and duly justified situations, to be extended to external audits of a partial nature or, that is, surgically intended for previously determined issues.

This level includes taxpayers not rated with an A, but whose fiscal organization and behavior score shows some credibility, although with signs that may give rise to some doubts.

Fourth level

Is also intended for taxpayers not rated with an A; but which nevertheless show a potentially compliant or credible fiscal organization and behavior.

This level does not presuppose any type of operational intervention, barely centering of the follow up of taxpayer voluntary compliance through the periodic compilation of filing information.

5.3 Risk analysis in operational planning

The planning process based on risk analysis, responds to a methodology that can be developed in the following phases:

1st phase – Classification and quantification of the risk for each taxpayer, considering the elements that characterize it: economic activity sector, economic and fiscal importance and fiscal organization and behavior.

2nd phase – Determination of the intensity of assistance required or, that is, the time that must necessarily be devoted to taxpayers of a specific segment to subsequently frame them within the corresponding levels of operational intervention.

3rd phase – After fulfilling the first two phases and, accordingly, having established the correspondence between the classifications and the levels of operational action, one continues to the 3rd phase which consists of calculating the resources necessary and the provisional results:

- i) calculate the number of companies, by sectors of economic activity, *rate* and *score*, thus quantifying the number of actions to be carried out, by type.
- ii) calculate the number of working days required
- iii) calculate the human resources required
- iv) calculate the provisional results – omitted tax, by working day and total

4th phase – Finally, the fourth phase consists of the elaboration of the operational examination plan, which covers the specific identification of the businesses to be examined, by sequence of priorities determined in the risk analysis, for each level of operational intervention and their assignment to the working teams and to the examiners who will carry out the work.

By way of example, shown below is a work assignment table, for planning purposes, which establishes the basic examination times, in days, for each operational level, although taking into account the activity sectors and the classification of taxpayer risk:

OPERATIONAL LEVELS	RATINGS	SCORING	ANTICIPATED EXAMINATION (IN DAYS)			
			BANKS	FINANCIAL CORPORATIONS	INSURANCE COMPANIES	NON FINANCIAL COMPANIES
I	A + others selected	1,2,3 & 4	60		60	60
II	B	1	40	30	25	25
		4	40	30	25	25
	C	1	25	15	20	20
		4	25	15	20	20
III	B	2	10	7.5	7.5	7.5
	C	2	7.5	5	5	5
V	B	3				
	C	3				

6. CONCLUSIONS

There is no doubt that for any follow-up and control of any type of activity, duly treated and analyzed information is the fundamental base for the effectiveness of the mission and of the objectives that are the source of existence of any organization.

Society in general and the citizen, in particular, demand that public powers that regulate and control the established norms, which are indeed expensive, be rationally used and that they be, above all, effective.

Therefore, fiscal control can and should not lack these principles, having ever more to base its action on processes counting on clear information, according to what is practiced in entrepreneurial management, in general, and which have in risk analysis a fundamental contribution.

In the meantime, risk analysis should not lead to strictly economic type vision of fiscal control or, that is, be merely aimed at those taxpayers where the omitted tax is potentially higher, and not disregarding reality, which consists of always considering that the greatest risk is where there is a potentially higher value of omitted tax.

Fiscal control strategies should always bear in mind the principles of equity and proportionality, with the risk analysis information being used to maximize the action in the chart showing these principles.

When selecting for examination, taxpayers with the highest levels of noncompliance, risk analysis favors the prevention of tax evasion and fraud, since it conveys to the community in general, an image of effectiveness, which leads to the perception of increased risk of noncompliance detection, improving accordingly, voluntary compliance with fiscal norms.

Risk analysis should not be an autonomous system, but should be included within an integrated risk management chart, that should comprise, in addition to taxpayer selection, other managerial components such as the strategy, human resources management and examination planning.

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